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CHOPPING DOWN THE FRUIT TREE: *CARUTH CORP. v. UNITED STATES* APPLIES ASSIGNMENT OF INCOME DOCTRINE TO GIFT OF STOCK BETWEEN DECLARATION AND RECORD DATES

The apportionment of taxes on the various descriptions of property, is an act which seems to require the most exact impartiality; yet, there is perhaps no legislative act in which greater opportunity and temptation are given to a predominant party, to trample on the rules of justice.

—James Madison, 1787*

INTRODUCTION

The primary function of the Internal Revenue Code ("Code") is to impose a federal tax on income. While the Code defines what is income,¹ what is not income,² when income is reported,³ and how income is reported,⁴ it provides little guidance as to *who* should pay tax on the income.⁵ The only relevant Code provision is section 61, which provides that gross income includes "all income from whatever source derived."⁶ Justice Holmes, in the landmark case of *Lucas v. Earl*,⁷ construed section 61⁸ as taxing income to those who earn it.

Throughout the years, taxpayers have attempted to assign income in an effort to decrease their tax liability.⁹ Generally, assignments of income take two forms:¹⁰ (1) situations where a taxpayer in a high income tax bracket attempts to shift income to a taxpayer in a lower income tax bracket, usually a family member, so that the income is taxed at the donee's lower rate,¹¹ and (2) situa-

* THE FEDERALIST NO. 10, at 132 (J. Madison) (B. Wright ed. 1961).

1. I.R.C. §§ 61, 71-90 (1988).

2. *Id.* §§ 101-135.

3. *Id.* §§ 441-444, 451-483.

4. *Id.* §§ 446-448.

5. Soll, *Intra-family Assignments: Attribution and Realization of Income* (pt. 2), 7 TAX L. REV. 61, 67 (1951).

6. I.R.C. § 61 (1988).

7. 281 U.S. 111, 114-15 (1930).

8. The counterpart to § 61 in 1930, the time *Lucas* was decided, was § 213(a) of the Revenue Act of 1918. Under § 213(a), net income included "income derived from salaries, wages, or compensation for personal services . . . of whatever kind and in whatever form paid." *Lucas*, 281 U.S. at 114 (quoting § 213(a)).

9. Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 YALE L.J. 991, 991 (1955).

10. *Estate of Applestein v. Commissioner*, 80 T.C. 331, 342-43 (1983).

11. *E.g.*, *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961) (father transferred

tions where a taxpayer donates property to a charity in an attempt to avoid the tax on the income from the property while taking a charitable deduction for the market value of the property.¹³

In both situations, the assignment of income doctrine¹³ operates to tax the donor on the income despite the fact that it is received by the donee. In *Lucas*, Justice Holmes stated that the fruits cannot be "attributed to a different tree from that on which they grew."¹⁴ This "apparently innocent figure of speech"¹⁵ imposed on the law of taxation the ever-present fruit-tree metaphor.¹⁶ In terms of the metaphor, the owner of the income-producing property (the tree) is taxed on the income (the fruit), even though the owner never receives the income. The corollary to the metaphor is that if the owner transfers the "tree," he is not taxed on any "fruit" that ripens after the gift.¹⁷

stock after dividend was declared to child); *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945) (husband donated successful court judgment to wife and children); *Usher v. Commissioner*, 45 T.C. 205 (1965) (taxpayer entered into binding contract to sell stock to third party and then, prior to actual sale, donated stock to family member); *Townsend v. Commissioner*, 37 T.C. 830 (1962) (taxpayer sold stock to third party, then donated sales contract to family members who were to receive the sales proceeds); *Cook v. Commissioner*, 5 T.C. 908 (1945) (father donated stock to sons after the corporation adopted a plan of liquidation); see *Estate of Applestein*, 80 T.C. at 342. In all of the above cases, the donor was taxable on the income because he donated the right to receive income after it had ripened.

The Tax Reform Act of 1986 diminished the utility of this type of assignment of income in two ways. First, the so-called "Kiddie Tax" rules tax a child at his parent's tax rate for unearned income such as interest, rent, and dividend income. I.R.C. § 1(i) (1988); see Baetz, *The Indefensible Kiddie Tax*, 126 TR. & EST. 27 (1987); Schmolka, *The Kiddie Tax under the Tax Reform Act of 1986: In Need of Reform While the Ink Was Still Wet*, 11 REV. TAX'N INDIVIDUALS 99 (1987). Second, the 1986 Act contained only two tax brackets for individual taxpayers. I.R.C. § 1 (1988). However, the 1990 amendments to the tax laws create a third tax bracket that revives, to some extent, the utility of this type of assignment. See Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 1101, reprinted in 1990 U.S. CODE CONG. & ADMIN. NEWS (104 Stat.) 1388.

12. E.g., *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976) (donor donated stock to charity after the corporation adopted a plan of liquidation); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973) (same); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972) (same); see *Estate of Applestein*, 80 T.C. at 343. In each of these cases, the court held the donor taxable on the income because the right to the income ripened before the time of the gift.

13. For an excellent discussion of the assignment of income doctrine, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962).

14. *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

15. Brown, *The Growing "Common Law" of Taxation*, 13 MAJOR TAX PLAN. 1, 15 (1961).

16. D. POSIN, *FEDERAL INCOME TAXATION OF INDIVIDUALS* § 5.05, at 282 (1983) (stating that "when Justice Oliver Wendell Holmes planted the tree in *Lucas v. Earl*, he doubtless did not know how great a tree would grow, how far its branches would reach, and where its fruits would fall"); Molloy, *Some Tax Aspects of Corporate Distributions In Kind*, 6 TAX L. REV. 57, 61 (1950) (stating that *Lucas* gave "rise to a truly lamentable host of horticultural metaphors").

17. See, e.g., Teschner, *Anticipation of Income*, 41 IND. L.J. 587, 588-89 (1966). The donor, however, is taxed on fruit that was already ripe at the time of the transfer. The ripened fruit constitutes income that has been realized and, therefore, is taxable. In reality, the donor is transferring a separate right to income along with the income-producing property.

More often than not, the metaphor is substituted for sound legal analysis.¹⁸ One commentator has suggested that judges use the fruit-tree metaphor because they are not comfortable with the tax laws, and therefore, "search for a property concept which could constitute a tree capable of being transplanted."¹⁹ By using this metaphor, judges can identify an income-producing "tree," and then restrict their inquiry to whether the "tree" was transplanted, in which case the tax burden is shifted to the donee, or whether only the "fruit" was transferred, in which case the donor remains taxable.²⁰

The fruit-tree metaphor simply is not adequate to analyze all situations. While labeling an item as "fruit" or "tree" may provide quick answers, the distinction between the "fruit" and the "tree" is often tenuous.²¹ As a result,

18. This view has been echoed by several commentators:

The metaphor has been substituted for rational analysis by courts and commentators to the point where a critic in this area cannot see the forest for the fruit trees. Metaphors lead nowhere: the number and extent of tax avoidance devices that have been employed here make a more rational analytical approach imperative if rational results are to be achieved.

Rice, *supra* note 9, at 991. See Brown, *supra* note 15, at 15 ("Beware the metaphor! Of all the anodynes for the pains of thought, it is the most seductive, the most misleading."). Justice Cardozo's admonition of metaphors is appropriate in this context: "Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." *Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

19. Brown, *supra* note 15, at 15; see also Davies, *The Shifting of Family Income For Income Tax Purposes*, 6 ST. LOUIS U.L.J. 281, 305 (1960); Del Cotto, "Property" in the Capital Asset Definition: Influence of "Fruit and Tree," 15 BUFFALO L. REV. 1, 7 (1965) (noting that Holmes' metaphor introduced the property concept into tax law); Durant, *Who Should Be Taxed on the Income From Property Owned by One Person, Legally or Equitably, but in the Legal Possession of Another?*, 7 INST. ON FED. TAX'N 920, 920 (1949) (noting that courts explain tax consequences in terms of property).

20. Brown, *supra* note 15, at 15. The court in *Caruth* fell prey to the fruit-tree metaphor in phrasing the issue in the case as "whether the fruit has been attributed to a different tree, or whether instead the entire tree has been transplanted." *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989).

21. This distinction can become blurred in certain instances. For example, in *Lum v. Commissioner*, 147 F.2d 356 (3d Cir. 1945), the taxpayer assigned to his wife the rents from one lease and the "rights as landlord" in another lease. *Id.* at 357. The court held that the donor assigned "fruit" in the first lease and the "tree" in the second lease because the "rights as landlord" constituted an interest in property. *Id.*

There are other examples of the misleading tendency of this metaphor. For instance, in *Helvering v. Eubank*, 311 U.S. 122 (1940), the Supreme Court held that the assignment of renewal contracts for insurance commissions was an assignment of income rather than an assignment of property. *Id.* at 125. On the other hand, oil brokerage contracts are considered income-producing property. *Carter v. Commissioner*, 9 T.C. 364, 370 (1947) (holding that assignments of commissions received in return for prior services was an assignment of property); see Tye, *Corporate Distributions—Some Current Trends*, 4 TAX L. REV. 459, 465-66 (1949).

The assignment of a lease is generally considered income. See *United States v. Shafto*, 246 F.2d 338 (4th Cir. 1957) (holding that the assignment of a five-year lease was ineffective to shift tax on rental income); *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954) (holding that the assignment of a twenty-year lease was ineffective to shift tax on rental income); Rev. Rul. 58-337, 1958-2 C.B. 13. Recall that in *Lum v. Commissioner*, the court considered the assignment of a lease with all of the donor/lessor's "rights as landlord" to be an assignment of property and not an assign-

the metaphor has limited utility and sometimes produces odd results in complex cases. In fact, in some situations, the person who owns the "tree" is not taxed,²² while in others, the person who transfers the "tree" is taxed.²³

An assignment of stock with a dividend does not fall squarely into either category, "fruit" or "tree."²⁴ The United States Court of Appeals for the Fifth Circuit recently addressed the question of who should be taxed on a dividend where a donor donates stock to a donee after a dividend has been declared but before the record date.²⁵ In *Caruth Corp. v. United States*,²⁶ the court held that the tax burden should fall on the donee.²⁷ The court succumbed to the fruit-tree metaphor and decided that since the donor gave away the stock (the tree), he should no longer be taxed on the dividend.²⁸ In so doing, the court ignored the fact that the dividend had sufficiently "ripened" at the time of the gift so as to hold the donor taxable.

This Note examines the *Caruth* court's decision and that court's erroneous approach to the tax consequences of a gift of stock after a dividend is declared but prior to the record date. The Background section begins with a review of the assignment of income doctrine. According to this doctrine, a person who earns income cannot escape its taxation by assigning it to someone else. Since *Caruth* was a case of relative first impression, the Background section draws

ment of income. *Lum*, 147 F.2d at 357.

The assignment of royalty contracts also illustrates the difficulty in distinguishing between income and income-producing property. An author, P.G. Wodehouse, assigned half his interest in manuscripts and all related rights to his wife. The Second Circuit held that the author assigned the income-producing property, and therefore, the assignment was effective to shift the tax to his wife. *Wodehouse v. Commissioner*, 177 F.2d 881 (2d Cir. 1949). On the same facts, the Fourth Circuit held that the author had assigned income, and therefore, the author/donor remained taxable. *Wodehouse v. Commissioner*, 178 F.2d 987 (4th Cir. 1949); see also 3 Fed. Tax Serv. (MB) § A:4.103[8] (1990); Ruden, *Assignment of Income, Though Difficult, Can Be An Effective Income Shifting Tool*, 4 TAX'N FOR ACCT. 74, 74 (1962) (discussing *Wodehouse* decisions); Shine, *Some Tax Problems of Authors and Artists*, 13 TAX L. REV. 439, 452-53 (1958) (same).

22. *Teschner v. Commissioner*, 38 T.C. 1003 (1962) (holding a taxpayer whose efforts created the right to receive income in the form of a winning sweepstakes ticket not taxable on the income because the taxpayer never had a right to receive it himself); J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* § 146, at 449 (2d ed. 1973); *Teschner*, *supra* note 17, at 589 & n.6.

23. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (holding that a corporation that negotiated and pre-arranged a sale of assets was taxable for the proceeds of the sale even though it distributed those assets to shareholders prior to the actual sale); *Teschner*, *supra* note 17, at 589 & n.5.

24. The court in the subject opinion recognized that the stock in *Caruth* was a "peculiar asset." *Caruth Corp. v. United States*, 865 F.2d 644, 645 (5th Cir. 1989).

25. With regard to a dividend, four significant dates occur: (1) the declaration date—the date the corporation determines that it will pay a dividend, (2) the record date—the shareholder of the stock on this date is entitled to receive the dividend, (3) the payment date—the date the corporation pays the dividend to the shareholder, and (4) the date of actual receipt—the date the shareholder receives the dividend from the corporation. Note, *Corporations—Dividends—To Whom Payable When Record Date is Given*, 7 OHIO ST. L.J. 437 (1941).

26. 865 F.2d 644 (5th Cir. 1989).

27. *Id.* at 651.

28. *Id.* at 649.

analogies to cases applying the assignment of income doctrine to both liquidating proceeds and contingent contracts because the courts in these cases utilized a different analysis than the court used in *Caruth*. Finally, the Background section surveys the case law on the assignment of stock and dividends.

Next, the Note focuses on the decision in *Caruth*. The Analysis section first discusses how the *Caruth* court misapplied the assignment of income doctrine. This section then provides an alternative analysis and holding. Finally, the Impact section identifies the future applications of *Caruth* in terms of tax avoidance opportunities.

I. BACKGROUND

A. Development of Assignment of Income Doctrine

Generally, assignments fall into three categories. First, a taxpayer can perform services and assign his compensation for these services to another person or entity. Second, a taxpayer who owns an income-producing property can assign the income that is generated from the property while still retaining the property. Third, the taxpayer can assign the income-producing property itself to another person or entity. All three of these assignments can take the form of either a gift or sale. The following three subsections separately examine each type of assignment in the form of a gift. Since the same principles apply to all three types of assignments when made for consideration, this section concludes with a discussion of the consequences of a sale.

1. Assignment of Income from Services

The assignment of income doctrine was introduced in 1930 by Justice Holmes in *Lucas v. Earl*.²⁹ In *Lucas*, a husband and wife formed a contract which provided that all future earnings of both parties were to be owned equally.³⁰ This contract had the effect of shifting half of the husband's income to the wife, who previously had no income.³¹ Despite the assignment to his wife, the Supreme Court held that the husband was required to pay tax on the full amount of his earnings.³² Writing for the Court, Justice Holmes gave birth to the now famous fruit-tree metaphor: one who earns income cannot escape the tax by "anticipatory arrangements and contracts however skillfully devised . . . by which the fruits are attributed to a different tree from that on

29. 281 U.S. 111 (1930).

30. *Id.* at 113-14. The couple did not form the contract in order to avoid paying income tax since the contract was created in 1901, prior to the enactment of the income tax laws. *Id.* at 114. Nevertheless, Justice Holmes stated that the absence of a tax-avoidance motive was irrelevant. *Id.* at 115.

31. Under the current Code, a spouse, like Guy Earl, could accomplish his income-splitting objective by filing a joint return. I.R.C. § 6013 (1988). In effect, the joint return provision in the Code that permits spouses to report income jointly can be regarded as a statutory assignment of income. Ruden, *supra* note 21, at 75.

32. *Lucas*, 281 U.S. at 115.

which they grew."³³

The *Lucas* case firmly established that income from services is taxed to the person who performed the services.³⁴ The fact that the donee had a legal right to receive the income is immaterial.³⁵ The decision instead focused on who *earned* the income.³⁶

The timing of the assignment, whether prior to or following the performance of services, is also immaterial.³⁷ In *Lucas*, the assignment occurred before the

33. *Id.* Technically, the metaphor was not truly applicable in the *Lucas* case, unless the husband was considered the "tree" and his earnings the "fruit." In subsequent cases dealing with income from property, the metaphor is more readily applicable. Holmes could not have imagined that his offhand reference to fruits and trees would be so widely used in later cases to explain and analyze the assignment of income doctrine. See D. POSIN, *supra* note 16, § 5.05, at 282 ("[W]hen Justice Oliver Wendell Holmes planted the tree in *Lucas v. Earl*, he doubtless did not know how great a tree would grow, how far its branches would reach, and where its fruits would fall.").

34. *Lucas v. Earl*, 281 U.S. 111, 115 (1930). The person who performed the services that generated the right to receive income cannot escape taxation by assigning the right to income. J. CHOMMIE, *supra* note 22, at 449; 34 AM. JUR. 2D *Federal Taxation* ¶ 5382 (1985); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8231; Fed. Tax Serv. (MB) § A:4.104; Durant, *supra* note 19, at 923; Lee & Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. CORP. L. 137, 187 (1987); Ruden, *supra* note 21, at 74; Shores, *Reexamining the Relationship Between Capital Gain and the Assignment of Income*, 13 IND. L. REV. 463, 499 (1980); Soll, *Intra-Family Assignments: Attribution and Realization of Income* (pt. 1), 6 TAX L. REV. 435, 438 (1951).

35. *Lucas*, 281 U.S. at 114. The Court recognized that the wife in *Lucas* had a legal right to receive the income. *Id.* It also recognized that the right to the income vested *after* the assignment. *Id.* at 115. However, the Court avoided deciding the case based on "attenuated subtleties" and decided instead that the husband had realized income. *Id.* at 114-15.

36. Lee & Bader, *supra* note 34, at 187. The concept of "earned" has a special significance in the area of tax law. For a more detailed discussion, see *infra* notes 162-63 and accompanying text. Where the donor assigns compensation income (wages, salaries, commissions, etc.), the person who "earns" the income is easily identified as the person who performs the services. However, when *income from property* is assigned, it is more difficult to determine the person who earned it. See Lyon & Eustice, *supra* note 13, at 389 n.372. Compare *Blair v. Commissioner*, 300 U.S. 579 (1937) (holding that donee earned income where donor assigned undivided, lifetime interest in income from trust) with *Harrison v. Schaffner*, 312 U.S. 579 (1941) (holding that donor earned income where donor assigned one year's worth of income from trust) and *Helvering v. Horst*, 311 U.S. 112 (1940) (holding that donor earned income where donor assigned interest income from bond but retained the bond).

37. *Helvering v. Eubank*, 311 U.S. 122 (1940); see also M. CHIRELSTEIN, L. DAY & E. OWENS, *TAXATION IN THE UNITED STATES* 436-37 (World Tax Series) (1963) [hereinafter M. CHIRELSTEIN] (donor taxed on income already accrued); 34 AM. JUR. 2D *Federal Taxation* ¶ 5382 (1985) (same); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8231 (same); Fed. Tax Serv. (MB) § A:4.104 (same); Lyon & Eustice, *supra* note 13, at 388-89 (same); Ruden, *supra* note 21, at 74 (same).

Before *Helvering v. Eubank*, courts held that *Lucas* was limited to assignments of future compensation because the donor/earner retained control over the income. *E.g.* *Burnet v. Leininger*, 285 U.S. 136 (1932). The donor/earner was viewed as having control over the income because any future earnings were contingent on the donor continuing to perform the services. See Soll, *supra* note 34, at 438 (quoting *Matchette v. Helvering*, 81 F.2d 73, 74 (2d. Cir. 1936)). The control rationale was further developed and applied in later cases such as *Helvering v. Clifford*, 309 U.S. 331 (1940). See *infra* notes 76-77.

taxpayer performed the services, and therefore, it was an assignment of *future* income.³⁸ This same principle readily applies if the taxpayer assigns income *previously* earned.³⁹ In *Helvering v. Eubank*, the taxpayer assigned commissions from insurance contracts.⁴⁰ The services that created the right to the renewal commissions had been previously rendered by the insurance agent.⁴¹ The Supreme Court held that assignments of the previously earned insurance commissions were taxable to the donor.⁴² Therefore, a taxpayer may not assign income from future or previously earned income.

The *Lucas* case has been followed in many areas. Thus, the wage earner/donor remains the proper taxpayer after an assignment of wages,⁴³ pensions,⁴⁴ and commissions.⁴⁵

2. Assignment of Income from Property

While *Lucas* held that a taxpayer could not shift the tax burden on compensation income, it did not address the consequences of an assignment of income from property. Income from property usually takes the form of interest, dividends, annuities, trust income, or royalties.⁴⁶ The Supreme Court promptly extended the *Lucas* rationale to income from property in the landmark *Helvering v. Horst* decision.⁴⁷

The *Horst* decision established that where the donor retains the property and assigns income earned from that property, the income is taxable to the

38. *Lucas*, 281 U.S. at 113-14.

39. *Eubank*, 311 U.S. at 122.

40. *Id.* at 124.

41. *Id.*

42. *Id.* at 125. The Court simply stated that the case was indistinguishable from *Horst* and offered no further analysis. *Id.* The fact that the renewal commissions were contingent on customers renewing the insurance policies apparently did not have a bearing on the result. For further discussion of the treatment of assignments of contingent contracts, see *infra* notes 154-74 and accompanying text.

43. *Johnson v. United States*, 698 F.2d 372 (9th Cir. 1982) (holding a basketball player taxable on his earnings even though they were paid to a third party); *Amsler v. Commissioner*, 51 T.C.M. (CCH) 978 (1986) (holding a musician taxable on his earnings even though paid to a trust); *Erskine v. Commissioner*, 26 B.T.A. 147 (1932) (holding an employee that assigned stock option after he exercised the option taxable on the option); see Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8232.

44. *Duran v. Commissioner*, 123 F.2d 324 (10th Cir. 1941) (holding an employee that assigned pension benefits taxable on the benefits); *Helvering v. Knapp*, 121 F.2d 454 (2d Cir. 1941) (holding a taxpayer that assigned pension benefits to a trust taxable on the benefits).

45. *McIver v. Commissioner*, 36 T.C.M. (CCH) 719 (1977) (holding a real estate broker that shared commission from sale of property with another broker taxable on the full amount of the commissions).

46. Ruden, *supra* note 21, at 74.

47. *Helvering v. Horst*, 311 U.S. 112 (1940). In terms of the fruit-tree metaphor, the donor held onto the "tree" (property) while giving away the "fruit" (income). Since the "fruit" is attributable to the donor's "tree," the donor must pay the tax on the "fruit." In the earlier, less complex cases, this metaphor adequately explained the assignment of income doctrine, which in return explains its early appeal to judges.

donor.⁴⁸ In *Horst*, a father gave his son detachable coupons⁴⁹ from a bond shortly before their due date but retained ownership of the bond.⁵⁰ The son collected the coupons at maturity.⁵¹ The Supreme Court held that because the father retained the property, he remained taxable on the income received by the son.⁵² The Court found no adequate basis for distinguishing between a gift of salary or commissions and a gift of interest coupons.⁵³

The Court reasoned that the gift of the coupons constituted a realization of the income.⁵⁴ This is an important issue because a taxpayer cannot be taxed on a gain from property until he "realizes" that gain. Income is realized when some particular event occurs that makes it convenient to determine the amount of gain.⁵⁵ Although a sale or exchange is the more common type of realization,⁵⁶ the Court stated that a taxpayer could also realize income when he completes the last step towards satisfaction of his economic gain.⁵⁷ This last step of the enjoyment of income in *Horst* was satisfying the desire to benefit the donee-son by transferring the income to him in the form of the coupon.⁵⁸ By possessing control over the right to dispose of the income, the father realized the income.⁵⁹

48. 311 U.S. 112 (1940).

49. Coupon bonds are bonds in which the holder collects his interest by detaching a "coupon" from the bond and presenting it to the debtor for payment.

50. *Horst*, 311 U.S. at 114.

51. *Id.*

52. *Id.* at 115.

53. *Id.* at 120.

54. *Id.* at 115.

55. *Id.*

56. Harrow, *Helvering v. Horst: Some Notes on Recent Applications of the Doctrine*, 6 INST. FED. TAX'N 1127, 1128 (1948) (realization is usually in the form of the sale or exchange of the property).

57. *Helvering v. Horst*, 311 U.S. 112, 115 (1940). The Court stated that the rule governing realization is "only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property." *Id.*

58. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.09, at 5-54 (rev. perm. ed. 1987).

59. *Horst*, 311 U.S. at 117. The Court in *Horst* identified two separate property rights in a bond: the right to receive the principal at maturity and the right to receive interest payments upon presentment of the coupons. *Id.* at 115. Since the father completely gave away his right to receive the interest from the coupons, one might wonder why the father should have been taxed on a property right with which he completely parted. The Court's rationale was that the taxpayer realized the income by having the power to dispose of it: "[t]he power to dispose of income is the equivalent of ownership of it." *Id.* at 118. Under the Court's theory, the gift of the income-producing property also constitutes realization since the taxpayer possessed the power to dispose of it. Since the Court considered the right to receive the interest payments a separate property right, then the disposition of that property right, under the Court's theory, arguably should shift the tax burden to the donee. However, the Court's theory proves too much since a gift of property clearly is not taxable to the transferor. I.R.C. § 102 (1988) ("Gross income does not include the value of property acquired by gift . . .").

The implication of the "enjoyment of income" rationale is that the assignment is the taxable event. Despite the strong language in the case, *Horst* has not been interpreted as considering the

The rationale of *Horst* was that by disposing of the income as he wished, the donor enjoyed the income as much as if he collected the income himself and then subsequently transferred it to his son.⁶⁰ The donor's transfer of the right to receive interest as a gift constituted a use of economic gain equivalent to the expenditure of money.⁶¹ The use of this economic gain, whether an expenditure of money or the transfer of a gift, is the enjoyment of income: "Even though he never receives the money, he derives money's worth from the disposition The enjoyment of the economic benefit . . . is realized as completely as it would have been if he had collected the interest in dollars and expended them."⁶²

Thus, the Court defined earned income based on the property owner's "enjoyment of income." The Court stated that the purpose of the taxation laws is the "taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid."⁶³ Simply stated, if the donor retains control over the income-producing property while assigning the right to income to someone else, he remains liable for the tax on the income from the property.⁶⁴ The key inquiry under the *Horst* doctrine, therefore, is who owned or controlled the income-producing property when the income was earned.

The *Horst* doctrine also applies to interest,⁶⁵ rent,⁶⁶ dividends,⁶⁷ partnership

gift a taxable event. *Austin v. Commissioner*, 161 F.2d 666 (6th Cir.), *cert. denied*, 332 U.S. 767 (1947); *Colby v. Commissioner*, 45 B.T.A. 536 (1941); *see also Commissioner v. First State Bank of Stratford*, 168 F.2d 1004, 1010 (5th Cir.) ("The acquisition of the right to receive payment of a bad debt is not necessarily a taxable event; and therefore the realization of the gain by the assignor is not deemed to occur until the debt is paid to the assignee."), *cert. denied*, 335 U.S. 867 (1948); *Lyon & Eustice*, *supra* note 13, at 355 n.244. These later decisions reasoned that the donor realizes income under the *Horst* doctrine when the donee actually receives the income. *Lee & Bader*, *supra* note 34, at 188 & n.332.

60. Although *Horst* considers disposing of the *income* realization, disposing of the *property* as one wishes is not considered realization for tax purposes although it may result in a similar "enjoyment" of the property. I.R.C. § 102 (1988) (stating that gross income does not include property acquired by gift). Thus, although *Horst* broadened the concept of realization to include the gift of income, *see Shine*, *supra* note 21, at 452, it did not go so far as to broaden realization to include the gift of property.

61. *Horst*, 311 U.S. at 117.

62. *Id.*

63. *Id.* at 119.

64. This is the prototype fruit-tree situation: where the donor keeps the tree and gives away the fruit, he is taxed on the fruit whenever it ripens. Essentially, the donor must include in her income any interest that had accrued as of the date of the gift. Rev. Rul. 58-275, 1958-1 C.B. 22 (stating that a cash basis donor must include interest income on the accrual basis); 34 AM. JUR. 2D *Federal Taxation* ¶ 5389 (1985). This effectively puts all taxpayers on the accrual basis for purposes of determining interest income. *See Harrow*, *supra* note 56, at 1128.

65. *Helvering v. Horst*, 311 U.S. 112 (1940). The Supreme Court held the donor taxable on interest earned after the assignment of the right to income because he retained ownership of the income-producing property. *Id.* at 118.

66. The donor is taxed on the rental income if he assigns the right to rent money while retaining a reversionary interest in the rental property. *United States v. Joliet & C.R. Co.*, 315 U.S. 44 (1941); *United States v. Shafto*, 246 F.2d 338 (4th Cir. 1957) (holding that an assignment of a five-year lease was ineffective to shift tax on rental income); *Galt v. Commissioner*, 216 F.2d 41

income,⁶⁸ royalty income,⁶⁹ legal fees,⁷⁰ trust income,⁷¹ and liquidating distri-

(7th Cir. 1954) (holding that an assignment of a twenty-year lease was ineffective to shift tax on rental income); *Ward v. Commissioner*, 58 F.2d 757 (9th Cir. 1932); Rev. Rul. 58-337, 1958-2 C.B. 13 (holding that assignment of a 10 year lease absent assignment of reversion constituted an assignment of income); see also 34 AM. JUR. 2D *Federal Taxation* ¶ 5391 (1985) (assignment of rent shifts tax burden only where assignee gets ownership interest in property); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8266 (same); Fed. Tax Serv. (MB) § A:4.103[7] (same); Lyon & Eustice, *supra* note 13, at 330-31 (same). The donee is taxed on the rental income if the donor assigns the rental property itself. *Bonkowski v. Commissioner*, 458 F.2d 709 (7th Cir. 1972).

Some disagreement exists over who is the proper taxpayer where the lessor assigns his "rights as landlord" as well as the lease. In *Lum v. Commissioner*, 147 F.2d 356 (3d. Cir. 1945), the lessor assigned three leases: in one assignment, he assigned merely the right to receive rent; in the other two, he assigned the lease with all his "rights as landlord." *Id.* at 357. The Third Circuit held that the donor/lessor was liable for the rents on the first lease because he merely transferred income while retaining the income-producing property. *Id.* The court held, however, that the other two leases were property interests under state law, and thus, effective to shift the burden of paying taxes to the assignee. *Id.*

In contrast, the Fourth Circuit held on similar facts that the donor/lessor made an assignment of income regardless of local law, and thus, taxed the assignor for the rents. *Shafro*, 246 F.2d at 338; Rev. Ruling 58-337, 1958-2 C.B. 13; see also *Galt*, 216 F.2d at 41 (assignment of twenty-year lease ineffective to shift tax burden). The courts in *Shafro* and *Galt* ruled that the income-producing property was the rental property and the lease merely evidenced the right to receive income. *Shafro*, 246 F.2d at 341; *Galt*, 216 F.2d at 47; see also Lyon & Eustice, *supra* note 13, at 331.

67. The donor is responsible for the tax on dividends if he assigns the dividends but keeps the stock. *Busch v. Commissioner*, 148 F.2d 798 (8th Cir. 1945) (holding a trust beneficiary taxable on future dividends assigned to creditor); *Hyman v. Nunan*, 143 F.2d 425 (2d Cir. 1944) (holding a donor taxable on the dividends where donor assigned right to future dividends without transferring the stock); *Newman v. Commissioner*, 1 T.C. 921 (1943) (holding a donor taxable on the dividends where donor assigned right to future dividends without transferring the stock); *Estate of Holmes v. Commissioner*, 1 T.C. 508 (1943) (holding a donor taxable on rights to accumulated dividends donated 15 days before maturity where donor held stock); see 34 AM. JUR. 2D *Federal Taxation* ¶ 5395 (1985); Harrow, *supra* note 56, at 1130; Lyon & Eustice, *supra* note 13, at 362; Fed. Tax Serv. (MB) § A:4.103[6]; Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8284. If the donor transfers the stock but retains a right to the dividends, then the donor is taxed on the dividend income. *Hemingway v. Commissioner*, 44 T.C. 96 (1965).

When the donor transfers the stock, the issue arises as to who is taxed on dividends already declared. This was precisely the issue in *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989).

68. *Commissioner v. Tower*, 327 U.S. 280 (1946) (holding a husband taxable on partnership income assigned to wife even though wife made a capital investment in the partnership); *Lusthaus v. Commissioner*, 327 U.S. 293 (1946) (same); *Burnet v. Leininger*, 285 U.S. 136 (1932) (holding a husband, who was a partner in a firm, taxable on his share of partnership income where he assigned future partnership income to his wife); see also Bruton, *Family Partnerships and the Income Tax—The Culbertson Chapter*, 98 U. PA. L. REV. 143 (1949); Paul, *Partnerships in Tax Avoidance*, 13 GEO. WASH. L. REV. 121 (1945); Veron, *Taxation of the Income of Family Partnerships*, 59 HARV. L. REV. 209 (1945); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶¶ J-8253 to J-8256.

69. Generally, if the donor assigns royalty income while retaining the underlying licensing agreement, the income is taxed to the donor. See *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Strauss v. Commissioner*, 168 F.2d 441 (2d Cir. 1948); *Lewis v. Rothensis*, 138 F.2d 129 (3d. Cir. 1943); *Eckel v. Commissioner*, 33 T.C.M. (CCH) 147 (1974); *Hopkins v. Commissioner*, 15 T.C. 160 (1950).

However, the assignment of the license agreement is an assignment of income-producing property, which shifts the tax liability to the donee. *Commissioner v. Reece*, 233 F.2d 30 (1st Cir. 1956); *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

One set of facts gave rise to two interesting and contrasting cases. An author, P.G. Wodehouse, assigned half his interest in manuscripts and all related rights to his wife. The Second Circuit held that the author assigned the income-producing property, and therefore, the assignment was effective. *Wodehouse v. Commissioner*, 177 F.2d 881 (2d Cir. 1949). On the same facts, the Fourth Circuit held that the author assigned income, and therefore, taxed the author/donor. *Wodehouse v. Commissioner*, 178 F.2d 987 (4th Cir. 1950); see also *Ruden*, *supra* note 21, at 74 (discussing the *Wodehouse* decisions); *Shine*, *supra* note 21, at 452-54 (same); Fed. Tax Serv. (MB) § A:4.103[8] (same).

70. In *Wilkinson v. United States*, 304 F.2d 469 (1962), a lawyer purchased a legal contingent fee contract, worked on the case for seventeen years, and then obtained a favorable judgement. *Id.* at 470. Before legal fees were awarded, the lawyer donated his attorney's fee contract to a charity. *Id.* Legal fees were in fact awarded and received by the charity. The taxpayer claimed a charitable deduction for the value of the fees donated. However, the taxpayer did not include the fees in income, claiming that he made a gift of appreciated property. *Id.* The court disagreed and held the lawyer taxable on the legal fees. *Id.* at 474. The court reasoned that the contingent fee contract was not property because the nature of the contract was merely a right to receive the income. Since the lawyer created the right to income with his personal efforts, he had to bear the tax consequences. *Id.* at 473-74.

71. In *Blair v. Commissioner*, 300 U.S. 5 (1937), a life beneficiary of a trust assigned a percentage of the future trust income for the full term of the life interest to his child. The Supreme Court held that the donor made a complete transfer of a property interest. *Id.* at 13. The Court stated that "[t]he assignment of the beneficial interest is not the assignment of a chose in action but of the 'right, title, and estate in and to property'. . . . We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income. . . ." *Id.* The portion that he assigned was a property interest which he completely assigned to his child. *Id.*; see also *Wood Harmon Corp. v. United States*, 311 F.2d 918, 923 (2d Cir. 1963) (discussing *Blair*); *Del Cotto*, *supra* note 19, at 8 (same). Therefore, the Court held that the assignment was effective to transfer the tax liability on the income. *Blair*, 300 U.S. at 14.

The definition of a "property interest" can be elusive. The court in *Wood Harmon Corp.* rejected the argument that the right to future income in that case was a property interest. *Wood Harmon Corp.*, 311 F.2d at 923. The court, in discussing the assignment in that case, stated:

[This was] not the sort of "transfer of beneficial ownership in property" which transfers the incidence of taxation under *Blair v. Commissioner*. In any case of an anticipatory assignment of rights to income, it is not difficult to cloak the assignment so that it masquerades as a transfer of a property right or capital asset, by arbitrarily assigning this label to the taxpayer's claim for future income. Wearing this disguise, even *Lucas v. Earl*, *Horst*, and *Eubank* would come within the *Blair* principle. . . .

The appellant's argument therefore proves too much.

Id. at 923 (emphasis in original).

The assignment in *Blair* is referred to as a "vertical slice" of the future income because the donor gave away a percentage of the income for every year of the life interest. D. POSIN, *supra* note 16, § 5.02, at 269-70; *Shores*, *supra* note 34, at 499. In contrast, a "horizontal slice" or "carved out interest" is the right to receive income for a set number of years less than the full life term. *Id.* For example, a right to receive 50% of the trust income for the full term of the trust is a "vertical slice"; while a right to receive all of the trust income for the next five years is a "horizontal slice."

The Court subsequently limited *Blair* in *Harrison v. Schaffner*, 312 U.S. 579 (1941). In *Schaffner*, the Court held that a gift of a one-year beneficial interest in a trust was not a substantial property interest, and therefore, the donor remained liable for the tax on the income. *Id.* at 583. Later cases held that a "horizontal slice" of at least ten years was a sufficient property interest to

butions from corporations.⁷² With an the assignment of income from property, the ownership or substantial control of the property, at the time the right to income is earned,⁷³ is controlling; the actual receipt of the income is

shift the taxability to the donee. *Hawaiian Trust Co. v. Kanne*, 172 F.2d 74 (9th Cir. 1949); *Farkas v. Commissioner*, 170 F.2d 201 (5th Cir. 1948); Rev. Rul. 55-38, 1955-1 C.B. 389. The ten-year period was logical because it coincided with the rules for the creation of a trust under § 673 of the 1954 Code. I.R.C. § 673 (1954); see 1 J. MERTENS, *supra* note 58, § 5.09; Lyon & Eustice, *supra* note 13, at 362; Shores, *supra* note 34, at 499. Under the 1954 version of § 673, a grantor of a trust could assign income for a period of ten years or greater and avoid the tax on the income during this period. I.R.C. § 673 (1954).

Under the 1986 revision of § 673, the ten-year period is replaced by a five percent of value rule: if the donor retains a reversionary interest which has a value that exceeds five percent of the value of the trust, then he is treated as the owner. I.R.C. § 673 (1986). Presumably, the Internal Revenue Service ("IRS") will continue to apply § 673 by analogy to the assignment of beneficial interests in trust income.

72. Upon liquidation, the corporation itself might be taxed on previously earned income assigned to stockholders. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 11.62, at 11-58 (4th ed. 1979); 34 AM. JUR. 2D *Federal Taxation* ¶ 5387 (1985); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶¶ J-8248 to J-8249. For example, in *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952), a corporation transferred accounts receivable to a stockholder after the corporation adopted a plan of liquidation. *Id.* at 595. Since the corporation used the cash basis of accounting, it did not report receivables as income until actually received. In this case, the receivables were received after the assignment. *Id.* The court held the corporation's former shareholder taxable on the accounts receivable because the income was fully earned by the corporation. *Id.* at 596. The court used the *Horst* rationale in stating that the power to dispose of income is the enjoyment of income, and hence, realization. *Id.*

Similarly, in *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959), a corporation assigned notes receivable to a stockholder after the plan of liquidation was adopted. The court held that the corporation was taxable on accrued interest on the note at the time of the transfer. *Id.* at 8.

The Second Circuit followed this reasoning in *Wood Harmon Corp. v. United States*, 311 F.2d 918 (2d Cir. 1963). In *Wood Harmon*, the corporation sold some property prior to liquidation and was entitled to receive the proceeds from the sale. *Id.* at 921. The court held that the corporation was taxable on the income from the sale, even though the income was later recovered by the stockholder, because the corporation earned the income by performing all the services. *Id.* at 923.

Similarly, the corporation is taxed on distributions of earned income even if the distribution is not pursuant to liquidation. In *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948), a corporation distributed as a dividend notes it had originally charged off as worthless but which later appeared collectible. *Id.* at 1005. The case could have been decided under the tax benefit rule. Under the tax benefit rule, the corporation must include any note later collected in income. I.R.C. § 22(b)(12) (1952). The corporation attempted to avoid this outcome by distributing the notes to its stockholders before they were collected. See Lee & Bader, *supra* note 34, at 201; Lyon & Eustice, *supra* note 13, at 400. Instead, the court based its decision on the assignment of income doctrine and ruled that the corporation was taxable on the notes. *First State Bank of Stratford*, 168 F.2d at 1010.

73. The general rules for the transfer of the income-producing property only apply when the gift is a bona fide transfer. Fed. Tax Serv. (MB) § A:4.103[4]. In contrast, if the donor purports to give up legal ownership, but retains substantial control over the property after the assignment, then the donor is treated as the owner and must pay the tax on the income from the property. *Helvering v. Clifford*, 309 U.S. 331 (1940) (holding a creator of a short-term trust who retained substantial control of the administration of the trust was taxable on the trust income). The Code treats a substantial reversionary interest in the property as evidence of sufficient control; if the

irrelevant.⁷⁴

3. Assignment of Income-Producing Property

The corollary of *Horst* is that where the taxpayer parts with ownership of the income-producing property itself, he is no longer liable for the tax on future income.⁷⁵ In terms of the language in the *Horst* decision, the taxpayer no longer can "enjoy" the income from the property because in addition to not

donor retains a reversionary interest which has a value that exceeds five percent of the value of the trust, then he is treated as the owner. I.R.C. § 673 (1988). Thus, the grantor of the trust must retain a very small reversionary interest, less than five percent, in the trust to avoid the taxation on the income. The IRS will look at substance over form in determining whether a genuine gift was made. *Duarte v. Commissioner*, 44 T.C. 193 (1965).

The groundwork for *Clifford* began ten years earlier in *Corliss v. Bowers*, 281 U.S. 376 (1930). In *Corliss*, the taxpayer created a trust that paid income to his wife for life with remainder over to their children. The taxpayer/grantor retained the right to modify or revoke the trust. In holding the taxpayer liable for the tax on the income, Justice Holmes stated:

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid

The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

Id. at 377. Thus, legal title to property is not necessarily determinative of the proper taxpayer. See *Durant*, *supra* note 19, at 923; see also *Burnet v. Wells*, 289 U.S. 670 (1933) (holding the grantor of trust taxable on trust income used to pay premiums on wife's life insurance policy); *Simon v. Commissioner*, 41 T.C.M. (CCH) 1328 (1981) (holding mother who exercised control over bank accounts legally transferred to two minor children taxable on income); *Marcello v. Commissioner*, 23 T.C.M. (CCH) 1877 (1964) (holding taxpayer who actively operated a bar lounge that he had transferred to his father-in-law taxable on the income from the bar), *aff'd on other grounds*, 380 F.2d 509 (5th Cir. 1967); *Dillon v. Commissioner*, 32 B.T.A. 1254 (1935) (holding parent who controlled property transferred to minor children taxable on income).

The *Clifford* line of cases and resulting Code sections, I.R.C. §§ 671-677 (1988), can be seen as both an extension of *Horst* and a limitation of *Blair*. *Horst* held that if the donor retains the income-producing property and gives away the income from that property, then he is taxable on the income. *Helvering v. Horst*, 311 U.S. 112 (1940). *Clifford* and its progeny extend this result to situations where the donor retains such control over the property that the donor is effectively treated as the owner. *Clifford*, 309 U.S. at 335. On the other hand, *Blair* held that an assignment of future income for the entire term of a life estate is a transfer of a property right, and thus, effective to shift the taxpayer. *Blair v. Commissioner*, 300 U.S. 5 (1937). *Clifford* limited this principle by requiring the grantor to make an irrevocable assignment for a period of at least ten years to avoid the tax liability. *Clifford*, 309 U.S. at 338.

74. *Horst*, 311 U.S. 112; *Blair*, 300 U.S. 5; see M. CHIRELSTEIN, *supra* note 37, at 438. The author states that "ownership of the underlying property at the time the income was accruing is deemed to be more significant for tax purposes than actual receipt of the income after it has accrued." *Id.*

75. *Blair*, 300 U.S. at 13 (holding that a beneficiary of trust who assigned an undivided share of his life interest was not taxable because he parted with ownership of his property); see, e.g., *Commissioner v. O'Donnell*, 90 F.2d 907 (9th Cir. 1937), *rev'd on other grounds*, 303 U.S. 370 (1938); see also *Ruden*, *supra* note 21, at 74 (transfer of property shifts tax burden to donee); 34 AM. JUR. 2d *Federal Taxation* ¶ 5381 (1985) (same); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8217 (same); Fed. Tax Serv. (MB) §§ A:4.103, A:4.104[2] (same).

receiving the income, he can no longer control the disposition of the income.⁷⁶ Since the new owner enjoys the income, he is the appropriate taxpayer.⁷⁷

Accordingly, a donor who transfers income-producing property that has appreciated in value does not realize⁷⁸ the gain attributable to the appreciation.⁷⁹ Rather, the appreciation in value is realized by the donee if he subsequently sells the property.⁸⁰ The result is that the donee pays the tax on the appreciation that occurred while the property was held by the donor and any later appreciation that occurred while it was held by the donee.⁸¹

Although the general rule is that the transfer of the property shifts the tax liability,⁸² the donor remains liable for the tax on any income already earned at the time of the gift.⁸³ The donee is then responsible for taxes on amounts earned after the assignment.⁸⁴ Where the income from property accrues ratably over time, such as interest and rent, the amount accrued at the time of the gift is taxed to the donor.⁸⁵ However, other types of income do not accrue with

76. Of course, if the transferor retains a right to the income and transfers the income-producing property, then the transferor is still responsible for the tax on the income. *Hemingway v. Commissioner*, 44 T.C. 96 (1965); see 34 AM. JUR. 2D *Federal Taxation* ¶ 5381 (1985); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8284.

77. See *Blair*, 300 U.S. at 13.

78. I.R.C. § 102 (1988). Despite the strong language in *Horst* implying that the assignment was the taxable event, the case has not been interpreted as considering the gift a taxable event. See *supra* note 59.

79. *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); *White v. Broderick*, 104 F. Supp. 213 (D. Kan. 1952); *Crowley v. Commissioner*, 34 T.C. 333 (1960); *Estate of Farrier v. Commissioner*, 15 T.C. 277 (1950); *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215 (1945); see also M. CHIRELSTEIN, *supra* note 37, at 438; 34 AM. JUR. 2D *Federal Taxation* ¶ 5381 (1985); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8223; *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004, 1010 (5th Cir.) ("Unrealized appreciation, since it is not taxable, is not covered by the rule as to anticipatory assignments of income."), *cert. denied*, 335 U.S. 867 (1948).

80. The donee's basis in appreciated property received as a gift is the donor's basis in the property. I.R.C. § 1015(a) (1988). Thus, when the donee sells the property, he will realize the value of the appreciation.

If the fair market value of the property is less than the transferor's basis, then the donee acquires a dual basis: his basis for purposes of gain is the donor's carryover basis, and his basis for purposes of loss is the fair market value of the property at the time of the gift. *Id.*

81. Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8223.

82. *Helvering v. Horst*, 311 U.S. 112 (1940).

83. *Austin v. Commissioner*, 161 F.2d 666 (6th Cir. 1947) (holding a payee of note who gratuitously transferred note taxable on accrued interest at date of gift); *Estate of Holmes v. Commissioner*, 1 T.C. 508, 511-12 (1943); see Rev. Rul. 69-102, 1969-1 CB 32; 34 AM. JUR. 2D *Federal Taxation* ¶ 5381; Lyon & Eustice, *supra* note 13, at 354 n.236; Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8222; Fed. Tax Serv. (MB) § A:4.103[1]; Recent Case, *Income Taxation—Donor of Income-Producing Property Subject to Tax on Accrued Income at Date of Gift*, 96 U. PA. L. REV. 282, 282 (1947). In terms of the fruit-tree metaphor, the donor is considered to have transferred a tree with ripe fruit. Since the fruit is ripe, the donor must pay the tax on it.

84. *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); *Commissioner v. O'Donnell*, 90 F.2d 907 (9th Cir. 1937), *rev'd on other grounds*, 303 U.S. 370 (1938); see Fed. Tax Serv. (MB) § A:4.103[4].

85. *Jones v. United States*, 395 F.2d 938 (6th Cir. 1968) (holding donor taxable on interest accrued at time of gift of endowment policies when received by donee); *Austin v. Commissioner*,

the mere passage of time but require some event to create the right to income. For example, dividends are not created until the corporation decides to issue them.⁸⁶ Thus, if a shareholder donates stock after a dividend has been declared and after the record date, the shareholder is taxed on the dividend because it was already earned at the time of the gift.⁸⁷

4. Assignment of Income for Consideration

The teaching of the *Horst* doctrine is that a donor remains liable for the tax on income if he gives away the right to income but retains the income-producing property. The previous sections have addressed the consequences of an assignment in the form of a gift. Where there has been a *sale* of income, the seller is not taxed on the income earned by the buyer.⁸⁸ Instead, he is taxed on the consideration from the sale.⁸⁹ While the proper taxpayer is known, the issue in these cases is the character of the seller's gain.⁹⁰ These cases are closely related to the gifts of income, and therefore, they help explain some of the gift assignments.

161 F.2d 666 (6th Cir. 1947) (holding that donor is taxable on interest accrued before transfer); *Anthony's Estate v. Commissioner*, 155 F.2d 980 (10th Cir. 1946) (holding donor liable on gift of interest in oil and gas lease and income therefrom); Rev. Rul. 72-312, 1972-1 C.B. 22; Rev. Rul. 69-102, 1969-1 C.B. 32 (holding donor taxable on cash surrender value of annuity contracts transferred near maturity).

The reasoning of these cases is entirely logical in light of *Horst*. The donor owned the property while the interest accrued, and thus, "enjoyed" this income upon the disposition of the income-producing property. "Accrued" with respect to interest and rent is synonymous with "earned" since interest accrues with the mere passage of time.

In *Austin*, 161 F.2d at 667, the payee of a note gave the note to her children at a time when approximately \$40,000 of interest had accrued. The Tax Court held the donor liable for the interest accrued while in the donor's hands. *Id.* at 667. According to the court, the income is taxable to the person who earns it regardless of whether he actually receives it or exercises his power to procure its payment to another. *See* Recent Case, *supra* note 83, at 282.

86. Rev. Rul. 74-562, 1974 C.B. 28.

87. Rev. Rul. 74-502, 1974-2 C.B. 28.

88. *Stranahan v. United States*, 472 F.2d 867 (6th Cir. 1973) (holding father who sold rights to future dividends to his son in an arm's length transaction taxable on consideration received from sale but not on future dividend income); *Cotlow v. Commissioner*, 228 F.2d 186 (2d Cir. 1956) (holding taxpayer who sold rights to his insurance renewal commissions taxable on consideration received from sale but not on future income); *see Lyon & Eustice, supra* note 13, at 389 n.373.

89. *See supra* note 88.

90. A gain can have two different characters: capital gain or ordinary income. A capital gain (or loss) arises on the sale or exchange of "capital assets," which generally includes all property held by the taxpayer except certain business assets. *See* I.R.C. § 1221 (1988). All other gains (such as salary, rent, interest, and dividends) are considered ordinary income.

As a result of the Tax Reform Act of 1986, capital gains are taxed at the same rate as ordinary income. However, the distinction between capital gains and ordinary income remains important because the deduction of capital losses is severely limited and because many Code provisions continue to rely on the distinction. In addition, the 1990 amendments to the tax laws revive, to some extent, the capital gains preference. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 1101, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS (104 Stat.) 1388.

In the gratuitous assignment of income cases, a critical inquiry is whether the donor gives away property, which shifts the tax to the donee, or income, which does not shift the tax to the donee. When a particular interest is *sold*, the same distinction is also crucial. However, when applied to a sale, the assignment of income doctrine determines not who pays the tax but whether the gain on the sale is to be treated as a capital gain or ordinary income.⁹¹ If the interest is a property interest, then the gain from the sale qualifies for capital gains treatment.⁹² If the interest is an income interest, which is not a capital asset,⁹³ then the income is treated as ordinary income.

The assignment of income doctrine was applied to the assignment for consideration area in *Commissioner v. P.G. Lake*.⁹⁴ The taxpayer in *P.G. Lake* sold a carved-out interest⁹⁵ in the future income of oil and gas property to a third party. The Supreme Court relied on assignment of income cases⁹⁶ and denied capital gains treatment on the grounds that the payment was a substitute for ordinary income.⁹⁷ The Court considered the interest sold as an income interest rather than a property interest.⁹⁸ Therefore, the Court held the taxpayer made an anticipatory assignment of ordinary income.⁹⁹

91. Del Cotto, *supra* note 19, at 10; Lyon & Eustice, *supra* note 13, at 304; Shores, *supra* note 34, at 464.

92. I.R.C. § 1221 (1988).

93. *Id.* Only property can be a capital asset.

94. 356 U.S. 260 (1958). The assignment of income doctrine was first applied to the assignment for consideration area in *Hort v. Commissioner*, 313 U.S. 28 (1941). In *Hort*, a lessee made a lump-sum payment to a lessor to cancel the lease. The Supreme Court analogized the lump sum payment to the interest coupon in *Horst*. The Court held that the lump sum should be treated as ordinary income, rather than a capital gain, because the payment was a substitute for future rent. *Id.* at 31. See Del Cotto, *supra* note 19, at 10. The author contends that the Court's rationale, substituting the lump sum for future ordinary income, proves too much. Under the Court's view, the sale of *any* property would result in ordinary income because the value of all property generally is composed of the ordinary income it will produce in the future. *Id.*

95. A carved out interest, or "horizontal slice," is an undivided interest in the future income from property for a set number of years, as opposed to a vertical slice, which is a partial interest for the entire life of the property. See *supra* note 71.

96. *P.G. Lake*, 356 U.S. at 267 (relying on *Lucas* and *Horst*).

97. *Id.* at 265.

98. *Id.*; see Del Cotto, *supra* note 19, at 18. Since the Court considered the interest in *P.G. Lake* an income interest rather than a property interest, the gratuitous assignment of income doctrine and the assignment of income for consideration area are now both analyzed in the same manner. In both areas, a "vertical slice" (interest coextensive in time with transferor's interest) is considered property and a "horizontal slice" or "carved out interest" (interest less in time than the transferor's interest) is considered income. D. POSIN, *supra* note 16, § 5.03. The assignment of the "vertical slice" shifts the taxpayer; the assignment of the "horizontal slice" does not. Del Cotto, *supra* note 19, at 18.

99. *Id.* at 267. *P.G. Lake* was an extension of *Hort* because the buyer in *P.G. Lake* was a third party instead of the party who would otherwise have made the future payments. Lyon & Eustice, *supra* note 13, at 304. Since the sale was to a third-party buyer, the interest continued in existence in the hands of the buyer after the transaction. Thus, the interest more closely resembled property than income. In contrast, the lease in *Hort* was extinguished by the lump-sum payment, thus the interest more closely resembled an advanced payment of income. D. POSIN, *supra* note 16, § 5.03.

P.G. Lake applied the assignment of income doctrine to the sale of property. However, different tax consequences arise between sales and gifts.¹⁰⁰ For example, if a father gave his son the right to receive future dividends from stock owned by the father, the father would remain liable for the tax on the dividend income later earned.¹⁰¹ However, if the father sold the right to future dividends to his son in an arm's length transaction, then the father is taxable only on the consideration received from the sale but not the dividends.¹⁰² The son/buyer is taxed on the future dividends.¹⁰³ Similarly, the gift of previously earned insurance commissions will not shift the tax liability to the donee,¹⁰⁴ but the sale of previously earned insurance commissions will shift the tax burden to the buyer.¹⁰⁵

To summarize the basic principles of the assignment of income doctrine, one must start with the proposition that income is taxed to the one who earns it.¹⁰⁶ In the case of income from services, the earner is easily identified as the person who actually performed the services creating the right to compensation.¹⁰⁷ In effect, a taxpayer cannot shift the tax liability on the income that he generated from his own services.¹⁰⁸ However, determining who "earned" the income

100. Ruden, *supra* note 21, at 74; Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8213; Fed. Tax Serv. (MB) § A:4.103[3].

101. Hyman v. Nunan, 143 F.2d 425 (2d. Cir. 1944) (holding the donor taxable on the dividends where donor assigned right to future dividends without transferring the stock); see *supra* note 64.

102. Stranahan v. United States, 472 F.2d 867 (6th Cir. 1973) (holding a father who sold rights to future dividends to his son in an arm's length transaction taxable on consideration received from sale but not on future dividend income); see Lyon & Eustice, *supra* note 13, at 389 n.373.

103. Ruden, *supra* note 21, at 74; Fed. Tax Serv. (MB) § A:4.103[3].

104. Helvering v. Eubank, 311 U.S. 122 (1940) (holding donor taxable on insurance commissions gratuitously transferred).

105. Cotlow v. Commissioner, 228 F.2d 186 (2d Cir. 1956) (holding taxpayer who sold rights to his insurance renewal commissions taxable on consideration received from sale, but not on future income); see Lyon & Eustice, *supra* note 13, at 389 n.373.

106. Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

107. Eubank, 311 U.S. at 124-25; Lucas v. Earl, 281 U.S. 111 (1930); see *supra* notes 29-45 and accompanying text.

108. *Lucas*, 281 U.S. at 115. Of course, if the earner performed the services as an agent, employee, or fiduciary for someone else, then he is not taxed on the income. *Teschner v. Commissioner*, 38 T.C. 1003 (1962); see Eustice, *Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case*, 20 TAX L. REV. 1, 43 (1964); *Teschner, New Case Restricts IRS Attempt to Extend Anticipatory Assignment of Income Doctrine*, 18 J. TAX'N 5 (1963); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8231. Also, the earner is not taxable on the income from his services if the earner never had a right to receive the income himself. *Teschner v. Commissioner*, 38 T.C. 1003 (1962).

In addition, if the taxpayer sold the right to income from his services, then he is not taxed on the future income. *Cotlow v. Commissioner*, 228 F.2d 186 (2d Cir. 1956) (holding a taxpayer who sold rights to his insurance renewal commissions taxable on consideration received from sale, but not on future income). See Lyon & Eustice, *supra* note 13, at 389 n.373. However, the proceeds are taxed as ordinary income. *Turner v. Commissioner*, 38 T.C. 33 (1962). Thus, the proceeds from the sale can be seen as a replacement for the income which is taxed immediately, instead of when the commissions are received.

is more difficult when property is involved. Generally, if the donor retains the income-producing property and assigns the income, the donor is taxed on the income.¹⁰⁹ Conversely, if the donor transfers the income-producing property (and does not retain control over the property after the transfer), then the donee is taxed on the income earned after the transfer.¹¹⁰ The donor remains liable, however, for the tax on income already earned at the time of the transfer.¹¹¹ Finally, in an assignment for consideration, the seller treats a sale of income as ordinary income and a sale of property as a capital gain, and the purchaser is taxed on income earned after the sale.¹¹²

B. Application of the Doctrine

The assignment of income doctrine gave courts a new weapon for preventing income shifting. Courts have used the doctrine in a variety of areas, including the assignment of income from liquidations,¹¹³ mergers,¹¹⁴ contingent contracts,¹¹⁵ and contest tickets.¹¹⁶

1. Liquidations and Mergers

Corporate liquidations provide an interesting analogy to dividends. Generally, when a corporation adopts a plan of liquidation, it thereafter sells its assets, pays its creditors, and then distributes a final liquidating dividend to its shareholders.¹¹⁷ A liquidation is similar to the declaration of a dividend; the liquidating dividend is "declared" at the adoption of the plan of liquidation¹¹⁸ and is payable to shareholders on the corporation's records on a date after the assets are sold.

If a stockholder gives away his stock *before* the corporation adopts a plan of

109. *Horst*, 311 U.S. at 116-17.

110. *Blair v. Commissioner*, 300 U.S. 5, 13 (1937).

111. See *supra* note 83 and accompanying text.

112. *Commissioner v. P.G. Lake*, 356 U.S. 260 (1958); see also *supra* note 94 and accompanying text (discussing tax consequences for sale of property).

113. *Dayton Hydraulic Co. v. United States*, 592 F.2d 937 (6th Cir. 1979); *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972).

114. *Estate of Applestein v. Commissioner*, 80 T.C. 331 (1983).

115. *Storz v. Commissioner*, 583 F.2d 972 (8th Cir. 1978); *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90 (2d Cir. 1957); *Donner v. Commissioner*, 227 F.2d 381 (2d Cir. 1955).

116. *Chelius v. Commissioner*, 17 T.C.M. (CCH) 121 (1958).

117. 19 C.J.S. *Corporations* § 811 (1990). Before 1986, § 337 allowed the corporation a 12-month period to wind up its liquidation without recognizing gains. I.R.C. § 337 (1954). Generally, the corporation did not recognize gain or loss on the sale of its assets if the corporation distributed all of its assets within the 12-month period. The Tax Reform Act of 1986 substantially modified § 337. See Tax Reform Act of 1986, Pub. L. No. 99-514, tit. 6, § 631(a), 100 Stat. 2269. Under current law, a liquidating corporation generally recognizes gain or loss on the corporate assets. See I.R.C. § 337 (1988).

118. See *Allen v. Commissioner*, 66 T.C. 340, 347 (1976) (holding that adoption of a plan of liquidation "amounted to the actual declaration of liquidations dividends").

liquidation, then he is not taxed on the liquidating dividend.¹¹⁹ Because the stockholder gives away the stock before the right to income has arisen, he cannot be said to have earned the income, and thus, he is not taxed on the liquidating dividend.¹²⁰

The Tax Court and each of the federal appellate courts that have addressed the issue have held that where a stockholder gratuitously transfers his stock *after* the plan of liquidation has been adopted but before the final distribution, the donor stockholder will be taxed on the liquidation proceeds.¹²¹

The Eighth Circuit, in *Hudspeth v. United States*,¹²² was faced with a case in which the donor gave away the liquidating dividend of a closely held corporation after a plan of liquidation was adopted.¹²³ The plan of liquidation was

119. *Winton v. Kelm*, 122 F. Supp. 649 (D. Minn.), *appeal dismissed*, 216 F.2d 957 (8th Cir. 1954) (holding donor not taxable on the liquidating proceeds after he donated stock shortly before the shareholders voted to liquidate); *Apt v. Birmingham*, 89 F. Supp. 361 (N.D. Iowa 1950) (same); *Stern v. Commissioner*, 15 T.C. 521 (1950) (same); FED. TAX. COORDINATOR 2d (Res. Inst. Am.) ¶ J-8228.

120. Note, *Jones v. United States: Tax Treatment of Gifts of Stock in a Liquidating Corporation*, 125 U. PA. L. REV. 682, 694 (1977) ("[L]iquidation proceeds are, in effect, 'earned' at the time the shareholders of a corporation vote to liquidate.").

121. *Dayton Hydraulic Co. v. United States*, 592 F.2d 937 (6th Cir. 1979); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1978); *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972); *Allen v. Commissioner*, 66 T.C. 340 (1976); *Cook v. Commissioner*, 5 T.C. 908 (1945).

Although the Fifth Circuit has never addressed precisely the same issue, the court held, under different facts, that the donee was taxable on the assignment of stock after the corporation adopted a plan of liquidation. *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971). In *Rushing*, all of the stockholders sold their shares to an independent trustee after the corporation adopted a plan of liquidation. Since the trustee owned all of the stock, it maintained the power to revoke the liquidation proceedings. *Id.* at 594. Because the transfer was a sale and not a gift, the issue before the court was *when* the income from the sale of the stock should be included in the seller's income, not *who* should pay the tax. See *Allen*, 66 T.C. at 348 (1976); Kovey, *Changing Shareholders in Contemplation of a Liquidation: The Planning Involved*, 47 J. TAX'N 82, 86 n.17 (1977). The court ruled that at the time of the sale, the stockholders had no absolute right to the liquidating dividend. *Rushing*, 441 F.2d at 598. Since the shareholders did not have an absolute right to the dividend at the time of the sale, the dividend did not accrue until the distribution date. Thus, the donor was not taxable on the liquidating dividend. *Id.* at 598.

Rushing was decided in 1971, before *Hudspeth*, *Kinsey*, and *Jones*. The court in *Rushing* relied on *Jacobs v. United States*, 390 F.2d 877 (6th Cir. 1968), an earlier Sixth Circuit case. The *Jacobs* court held that since the shareholders could revoke the plan of liquidation, the donor was not taxable on the liquidating dividend because the shareholder's right was not absolute until the distribution date. *Id.* at 877. The Sixth Circuit subsequently overruled *Jacobs* in *Jones v. United States*, 531 F.2d 1243 (6th Cir. 1976), and followed *Hudspeth* and *Kinsey*.

Rushing is distinguishable from *Hudspeth*, *Kinsey*, and *Jones* in that *Rushing* involved a sale rather than a gift, and therefore, the court was not deciding who should be held accountable for the tax. Also, the donee in *Rushing* maintained sole power to revoke the liquidation proceeding. Thus, there was less certainty than in the later liquidation cases. The level of certainty is a key element in determining whether income is taxed to the donor. Compare *Helvering v. Horst*, 311 U.S. 112 (1940) (holding donor taxable where income was certain to be realized) with *Teschner v. Commissioner*, 38 T.C. 1003 (1962) (holding donor not taxable where income was uncertain).

122. 471 F.2d 275 (8th Cir. 1972).

123. *Id.* at 276. The plan of liquidation was entered into on April 10, 1964. The donor trans-

theoretically revocable by the shareholders at the time of the gift.¹²⁴ Thus, the stockholders did not have an absolute right to the dividend at the time of the gift.¹²⁵ However, since the donor retained sufficient stock to maintain control over the corporation, he could ensure that the revocation would never occur.¹²⁶ Despite the fact that the donor shareholder was not "absolutely and indefeasibly entitled in the immediate future to the liquidating distributions on the stock donated,"¹²⁷ the court held that the donor was liable for the tax on the liquidating dividend.¹²⁸ The court looked at the "realities and substance" of the transaction rather than the formalities and remote hypothetical possibilities.¹²⁹ The "realities and substance" of the events were that the donor donated proceeds from the liquidation to the donee, and thus, the donor was taxed on the proceeds.¹³⁰

The Second Circuit, in *Kinsey v. Commissioner*,¹³¹ followed the reasoning of the Eighth Circuit.¹³² After the corporation adopted a plan of liquidation, the donor transferred shares representing 56.8% of the corporation to the donee.¹³³ Theoretically, the plan of liquidation was revocable by the shareholders.¹³⁴ However, under state law,¹³⁵ a two-thirds vote by the shareholders was required to rescind the liquidation.¹³⁶ Adopting the "realities and substance" approach of the Eighth Circuit, the court held that the donor was taxable on

ferred the shares on January 21, 1965. The corporation distributed the liquidating dividend on February 10, 1965. *Id.* The right to the liquidation proceeds accrued on March 12, 1965, the date the corporation's board of directors passed the final resolution of dissolution. *Id.* at 280.

124. *Id.* at 277. The corporation could revoke the liquidation by majority vote up until March 12, 1965, the date the corporation filed the Articles of Dissolution. *Id.*

125. The district court viewed this fact as determinative under the authority of *Jacobs v. United States*, 390 F.2d 877 (6th Cir. 1968), which was subsequently overruled by *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976). For a discussion of *Jacobs*, see *supra* note 121 and *infra* note 140. *Hudspeth v. United States* 335 F. Supp. 1401, 1404 (E.D. Mo. 1971), *rev'd*, 471 F.2d 275 (8th Cir. 1972).

126. *Hudspeth*, 471 F.2d at 279.

127. *Id.* at 277 (quoting *Hudspeth*, 355 F. Supp. at 1404).

128. *Id.* at 280.

129. *Id.* at 277.

130. *Id.* at 280. Essentially, the court held that the donor gave away income instead of property. In substance, "the shares transferred were merely empty vessels by which the taxpayer conveyed the liquidation proceeds." *Id.* at 279. Thus, the shareholders "made contributions not of stock, but of the proceeds of the liquidation." *Id.* at 280.

131. 477 F.2d 1058 (2d Cir. 1973). For a discussion of *Kinsey*, see Note, *Taxation of Gifts of Stock in a Liquidating Corporation*: *Kinsey v. Commissioner*, 1974 WASH. U.L.Q. 309 (1974).

132. *Kinsey*, 477 F.2d at 1061. The donor argued that he was not liable for the liquidating proceeds because the gift was made before the corporation passed the final resolution of dissolution--the time at which the liquidation is no longer revocable, and therefore, the time the proceeds accrued. *Id.* at 1063.

133. *Id.* at 1059-60.

134. Thus, the stockholders did not have an absolute right in the dividend at the time of the gift.

135. CONN. GEN. STAT. ANN. §§ 33-376(c), 329(d) (West 1987).

136. *Kinsey*, 477 F.2d at 1060.

the liquidation proceeds.¹³⁷ In substance, the donee could not revoke the liquidation by itself, and the other stockholders would not revoke the liquidation because adverse tax consequences would result.¹³⁸ Since the liquidation was practically certain to occur, the court refused to consider the remote, theoretical possibility of rescission of the liquidation.¹³⁹

In *Jones v. United States*,¹⁴⁰ the Sixth Circuit expanded the rulings of the Eighth and Second Circuits.¹⁴¹ A noncontrolling donor of a publicly held corporation transferred shares after a plan of liquidation was adopted.¹⁴² Despite the donor's lack of control over the corporation,¹⁴³ the court held that the donor anticipatorily assigned the liquidation proceeds, and therefore, was liable for the tax.¹⁴⁴ The court adopted the "realities and substance" test of the Eighth and Second Circuits and concluded that the liquidation was practically certain to occur.¹⁴⁵ The mere possibility of rescission was not enough.¹⁴⁶

137. *Id.* at 1063 (quoting *Hudspeth v. United States*, 471 F.2d 275, 277 (8th Cir. 1972)).

138. *Id.* The other stockholders would not revoke the liquidation because a revocation would have caused their distribution to be treated as ordinary income rather than a more favorable capital gain. *Id.*

139. *Id.*

140. 531 F.2d 1343 (6th Cir. 1976). The decision in *Jones* overruled the Sixth Circuit's earlier decision in *Jacobs v. United States*, 390 F.2d 877 (6th Cir. 1968), *aff'g per curiam* 280 F. Supp. 437 (S.D. Ohio 1966). In *Jacobs*, the donor donated stock to a charity after the corporation adopted a plan of liquidation. 280 F. Supp. at 438. Since the liquidation plan could theoretically be revoked by the shareholders, the donor did not have an absolute right to the dividend at the time of the gift. Thus, the court held that the donor was not taxable on the liquidating dividend. *Id.* at 439; *accord* *Dayton Hydraulic v. United States*, 592 F.2d 937 (6th Cir. 1979). In *Dayton*, a subsidiary corporation adopted a plan of liquidation. The parent corporation redeemed the stock of one of its own shareholders with the stock of the liquidating subsidiary. *Id.* at 938. The Sixth Circuit followed its decision in *Jones* and held the parent corporation taxable on the liquidation proceeds. *Id.* at 939. For a discussion of the *Jones* case, see Note, *supra* note 120, at 682 (urging a *per se* rule that the donor is always taxable on liquidating proceeds from stock donated after the adoption date regardless of how much control he had owned before or after the gift).

141. In contrast to *Hudspeth* and *Kinsey*, the donor in *Jones* did not have control of the corporation, owning only 10% of the voting stock. *Jones*, 531 F.2d at 1344. The decision also was an expansion of *Hudspeth* and *Kinsey* in that those cases dealt with closely held corporations. In *Jones* the corporation was publicly held.

142. *Id.* at 1343.

143. *Id.* at 1346. The court regarded control as only one factor in determining whether the liquidation was practically certain to occur. *Id.* Other factors indicated that the liquidation was practically certain to occur notwithstanding the absence of control: (1) the taxpayer expected the liquidation to be completed, (2) the other shareholders would most likely not revoke the liquidation because they would lose the tax advantages of § 337, and (3) the shareholders voted to adopt the plan by an overwhelming majority (968,605 to 175). *Id.* at 1345.

144. *Id.*

145. *Id.*

146. *Id.* at 1346. In *Allen v. Commissioner*, 66 T.C. 340 (1976), the Tax Court also adopted the "realities and substance" test. In *Allen*, the shareholders were doctors who donated 75% of their stock to a charity after the corporation adopted a plan of liquidation. *Id.* at 341, 343, 345. Since the charity now owned 75% of the stock, it had the voting power to rescind the plan of liquidation. *Id.* at 345. The doctors, relying on *Jacobs*, argued that since the plan was rescindable, they should not be taxed because they did not have an absolute right to the liquidating dividend.

The analysis developed by the courts in the liquidation cases has also been applied in the merger context. In *Estate of Applestein v. Commissioner*,¹⁴⁷ a father donated stock¹⁴⁸ to his children after the shareholders approved a merger agreement but before the effective date of the merger.¹⁴⁹ The court held that the donor was taxable on the merger proceeds because the merger was practically certain to occur.¹⁵⁰ Since the right to the income had sufficiently matured, or "virtually ripened,"¹⁵¹ at the time of the gift, the donor was taxed on the merger proceeds notwithstanding that, in form, he transferred the income-producing property. In substance, the stock was "nothing more than a vehicle" for the right to receive income from the merger.¹⁵² "The stocks transferred were thus hollow receptacles by which the petitioner conveyed the merger proceeds to his children. All the children had to do was to allow the stock to sit in their custodial accounts for a day or two and then hold out their caps to receive the proceeds."¹⁵³

2. Contingent Contracts

The contingent contract cases follow the reasoning of the liquidation and merger cases that a donor is taxable on income even though the income was not fixed and absolute at the time of the gift. The contingent contracts in these cases are contracts that have been substantially or completely performed, but are contingent and/or uncertain in the amount of income to be received.¹⁵⁴ Despite the fact that the right to the income is not fixed and absolute, the donor is taxable on contingent contracts assigned to the donee.¹⁵⁵

Many times the contingent contract issue arises upon the liquidation of a corporation. In *J. Ungar, Inc. v. Commissioner*,¹⁵⁶ an accrual basis¹⁵⁷ corpora-

Id. Despite this fact, the Tax Court, using the "realities and substance" test, determined that the right to receive the liquidating dividend had so matured and ripened at the time of the gift that the donors could not avoid the tax on the liquidating dividend. *Id.* at 346. The liquidating proceeds had ripened because no further action was required by the corporation or shareholders to complete the distribution of the proceeds. *Id.* at 347. The Tax Court stated that "[t]he liquidation . . . proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares." *Id.* at 348. Thus, the court held the donor taxable. *Id.*

Interestingly, the Tax Court compared *Jones, Kinsey, and Hudspeth* with *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d. Cir. 1961), where the court held the donor taxable on dividends from stock transferred after the declaration date but before the record date. *Allen*, 66 T.C. at 347.

147. 80 T.C. 331 (1983).

148. Actually, the father made a bargain sale to his children. The bargain portion of the sale is considered a gift. *Id.* at 336.

149. *Id.* at 345.

150. *Id.* at 346.

151. The Tax Court explained that "the timing of the transfer makes it clear that petitioner's right to the merger proceeds had virtually ripened prior to the transfer." *Id.*

152. *Id.* at 345.

153. *Id.*

154. *E.g.*, *Storz v. Commissioner*, 583 F.2d 972 (8th Cir. 1978).

155. *Id.*; *J. Ungar Inc. v. Commissioner*, 244 F.2d 90 (2d Cir. 1957).

156. 244 F.2d 90 (2d Cir. 1957). The corporation was an agent for a Spanish olive exporter

tion distributed to its sole stockholder at liquidation the right to collect future commissions.¹⁵⁸ Since the amount of the commissions could not be determined at the time of the distribution, they had not yet accrued,¹⁵⁹ and thus, were not included in the corporation's income. The Second Circuit, in an opinion written by Judge Learned Hand, held that although the income had not yet accrued under accounting principles, the income was earned by the corporation because it performed all of the services required to create the right to income.¹⁶⁰ Thus, the corporation was held taxable on the income.¹⁶¹

"Earned" has a special meaning in the assignment of income area. The word in this context is broader than the dictionary definition.¹⁶² Instead, income is "earned" if its realization "has become sufficiently proximate in time, or in likelihood, that the donor of the right to receive it cannot escape taxation."¹⁶³ This definition is important because the taxpayer who controls the source of the income at the time the income is earned is taxable on that income.

The Eighth Circuit further explained the rationale for taxing the transferor corporation on contingent contracts in *Storz v. Commissioner*.¹⁶⁴ The court

and received commissions based on a percentage of sales. *Id.* at 91. The corporation was not entitled to receive its commissions until the goods were shipped. *Id.*

157. Under the accrual basis of tax accounting, an item of income accrues when all events necessary to entitle the taxpayer to a fixed and determined right to the income have occurred. Treas. Reg. § 1.461-1(a)(2) (1957). However, all events cannot occur before economic performance occurs. I.R.C. § 461(h) (1988).

158. *J. Ungar*, 244 F.2d at 92. The shareholder also received cash, commission receivables, and chattels. *Id.*

159. An item of income does not accrue until it is fixed and determined.

160. *J. Ungar*, 244 F.2d at 93. One commentator has noted:

The element of contingency or uncertainty does bear on the proper time for reporting income as a matter of tax accounting, but such fact should not be allowed to obscure or control the fundamentally different question of whom is the proper person to pay the tax on such income when it does eventually become reportable.

Eustice, *supra* note 108, at 43.

161. Likewise, the corporation was taxed on substantially performed contingent contracts distributed in liquidation in *Donner v. Commissioner*, 227 F.2d 381 (2d Cir. 1955). The corporation constructed numerous homes on parcels of land it owned and contracted to sell most of the homes. At that point, the corporation distributed in liquidation all of its property to its stockholders. The stockholders then officially closed title on the homes and collected the proceeds. *Id.* at 382. The court held the corporation taxable on the income from all of the sales because, although not certain and absolute, the right to income was relatively well determined at the time of the distribution. *Id.*

162. See BLACK'S LAW DICTIONARY 456 (5th ed. 1979) (stating that earn means "to acquire by labor, service, or performance").

163. Note, *supra* note 120, at 694 n.64; see also Recent Decision, *Taxpayer Who Generates Income and Designates Its Recipient Held Not Taxable Thereon When He Has No Right to Receive It*, 24 MONT. L. REV. 183, 184 (1963) (stating that earn "in its broadest sense means to generate or produce income").

164. 583 F.2d 972 (8th Cir. 1978). In that case, a liquidating corporation assigned substantially completed underwriting contracts to a buyer. *Id.* at 973. Since the corporation was on the accrual basis, the income from the contracts was not recognized until all contingencies were satisfied and the contract was complete. *Id.* Furthermore, the corporation did not have a right to

recognized that income could be earned despite the fact that it had not yet accrued. It stressed the distinction between the two concepts. The concept of "earn" is relevant to the question of *who* is the proper taxpayer.¹⁶⁵ The concept of "accrue," on the other hand, is relevant to the question of *when* income becomes taxable.¹⁶⁶ The court concluded that it is "entirely possible that income may have been earned, but not yet realized because not yet accrued."¹⁶⁷ Thus, the court provided a rationale for taxing contingent contracts to the transferor based on who earned the income, regardless of whether the income has accrued.¹⁶⁸

However, some courts determine whether income is "earned" by the level of certainty that exists in its collection. For example, in *Cold Metal Process Co. v. Commissioner*,¹⁶⁹ the corporation distributed the rights to several settled lawsuits to its sole shareholder. The collection of the lawsuits was contingent on actions of the government in releasing the damage award to the corporation.¹⁷⁰ Several years later, the government relented and the funds were released, thereby satisfying the contingency.¹⁷¹ The court recognized that although not yet accrued, income could be earned at the time of a transfer.¹⁷² However, in the case before it, the court ruled that the income was not "earned" at the time of distribution because it was too uncertain.¹⁷³

In sum, the contingent contracts cases demonstrate that income may be considered "earned" before it has accrued. Although an item of income might not be fixed and determined, and therefore not accrued, the income could very

payment until the contracts were complete. *Id.* The selling price of the contracts included the value of the contracts that the buyer was about to receive. *Id.* The court held that the income from the contracts was taxable as corporate income. *Id.* at 977.

165. *Id.* at 975. The court stated that the corporation "cannot avoid taxation by assigning the fruit of its efforts to another, when the fruit however green, has a market value at the time of assignment. The assignment of income doctrine causes income to be taxed to him who earns it." *Id.*

166. *Id.* As the court stated, "income is taxable only when it has been realized under an acceptable accounting method. The accrual method of accounting generally provides that realization occurs when the taxpayer has fixed right to a reasonably ascertainable sum." *Id.* (citing Treas. Reg. § 1446-1(c)(ii)).

167. *Id.* at 976.

168. See Lyon & Eustice, *supra* note 13, at 389. This reasoning applies to the transfer of contingent contracts outside of liquidation. *Eubank v. Commissioner*, 311 U.S. 122 (1940); 34 AM. JUR. 2D *Federal Taxation* ¶ 5396 (1985); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8230; Fed. Tax Serv.-(MB) § A:4.106. For example, in *Eubank v. Commissioner*, 311 U.S. 122 (1940), an insurance agent assigned renewal commissions that were contingent and uncertain in amount. The Supreme Court held that the donor was liable for the tax when the donee received the income. *Id.* at 127.

169. 247 F.2d 864 (6th Cir. 1957).

170. *Id.* at 872. At the time of the distribution, the government was contesting the corporation's legal right to the money. Due to this uncertainty, the money had not yet accrued, nor had it been earned. *Id.*

171. *Id.* at 868-71.

172. *Id.* at 872.

173. *Id.*

well be considered earned. In such a case, the income would be taxed to the corporation. The contingent contract cases also introduce the level of certainty as a factor in determining whether income is earned. Although, theoretically, the level of certainty should not affect the determination of whether income is earned,¹⁷⁴ some courts do not consider income that is relatively uncertain to be earned. This uncertainty factor is also applicable to the contest ticket cases.

3. Contest Tickets

Another type of assignment of uncertain income is the assignment of a contest ticket such as a lottery ticket, racing ticket, or writing contest entry. The issue in this area is who should pay the tax on the income from a winning ticket where the buyer of the ticket donates the right to the income before the drawing.¹⁷⁵ The assignment of a contest ticket presents an interesting test for the assignment of income doctrine because although the donor created the right to the income, the right to the income is very uncertain at the time of the assignment. The Internal Revenue Service ("IRS") took the position that the donor should be liable for the tax because it was his personal effort that created the right to the income.¹⁷⁶ The Tax Court, however, held that the donee is taxable because the right to income is too uncertain at the time of the gift.¹⁷⁷ Thus, even though, in theory, the level of uncertainty should not affect

174. See *supra* note 160.

175. If a taxpayer assigns the contest ticket *after* the drawing, then the donor is responsible for the tax. *Braunstein v. Commissioner*, 21 T.C.M. (CCH) 1132 (1962). This is logical in light of *Horst* because the donor had a certain, ascertainable right to income at the time of the assignment.

176. Rev. Rul. 58-127, 1958-1 C.B. 42. This revenue ruling dealt with a taxpayer who entered a contest, designating that should he win, the prize would go to his daughter. When the taxpayer's entry was selected as the winning entry, the sponsor of the contest sent the taxpayer a check payable to his child, and made no restrictions on the use of the funds. The IRS ruled that the taxpayer was taxable on the prize because his personal efforts created the right to receive the income. The taxpayer's anticipatory arrangement to vest income to the child did not relieve him of the tax. *Id.* at 43; see also Rev. Rul. 58-235, 1958-1 C.B. 26. The donor agreed to participate in a quiz show provided that any prize he won would be paid directly to a tax-exempt organization in which the donor was a director. The donor won a prize, which was paid to the tax-exempt organization. The IRS ruled that the donor was taxable on the income because he created the right to receive income through his personal efforts. *Id.* at 27-28.

177. *Chelius v. Commissioner*, 17 T.C.M. (CCH) 121 (1958). In *Chelius*, the donor orally assigned, to a family member, his right to receive the income from a sweepstakes ticket before the drawing. The Tax Court held that the donee was taxable because the right to income was too uncertain. *Id.* at 125.

If the donor assigns the right to the income after the ticket is determined to be the winning ticket, then the income is no longer uncertain and is taxable to the donor. *Braunstein*, 21 T.C.M. at 1132. In *Braunstein*, there were two levels of prizes. First, several tickets were selected as preliminary winners and assigned to a horse in a race. *Id.* Second, the ticket representing the winning horse won the grand prize. The donor in the case assigned his ticket after he won the preliminary prize but before the final race. The court held the donor was taxable on the preliminary prize. *Id.* at 1134-35. The court reasoned that the taxpayer assigned the ticket after his ticket had been selected as a winner, and therefore, had a right to collect the preliminary prize.

the time at which income is earned, the donee of a contest ticket is taxable.

The contest ticket cases represent the opposite end of the spectrum from *Horst*. In *Horst*, realization of the interest income was guaranteed because interest is earned with the mere passage of time. Thus, in *Horst*, the court held the donor was taxable because he donated income that was certain to accrue.¹⁷⁸ In the contest ticket cases, however, the right to receive the income was very uncertain. Thus, courts have held that the donor was not taxable.¹⁷⁹

Id. at 1135.

In *Teschner v. Commissioner*, 38 T.C. 1003 (1962), the Tax Court ruled that the donee should be liable for the tax on the assignment of an entry to an essay contest. The donor was precluded, however, from ever receiving the prize. *Id.* at 1006. Thus, the Tax Court was faced with a situation where the donor created the right to income through his personal efforts but could never receive the income himself. The IRS argued that the donor should be taxed because his efforts created the right to receive the income, notwithstanding that he could never receive it himself. *Id.* It reasoned that since the donor had the power to dispose of the income, which under *Horst* is equivalent to realization, the donor should be taxed on the income. *Id.* at 1007.

The Tax Court rejected the argument and held that the donor was not taxable on the income. *Id.* The Tax Court conceded that the power to dispose of income is tantamount to realization under the *Horst* doctrine. However, the court ruled that in the case before it, the donor did not have the "power to dispose" because the power to dispose presupposes that the donor had a right to possession. *Id.* at 1007. The strong implication from the *Teschner* case is that a taxpayer could not be taxed on income unless he had a right to receive it at some point in time. See Recent Decision, *supra* note 163, at 183.

Commentators are also split on the issue. Eustice believes that the donor should have been taxed since his efforts created the right to the income and the corresponding power to dispose of it. He analogized the lottery ticket to a trust in which the grantor retains the power to designate the recipient of the income from the trust. Such income from a trust is taxed to the grantor. Likewise, Eustice concludes, the donor of the lottery ticket who had the power to designate the recipient of the income should be taxed. In both situations, the person who "earned" the income should pay the tax on it. Eustice, *supra* note 108, at 44; see also Note, *Prize Payable to Taxpayer's Daughter and Produced by His Efforts Taxed to Daughter*, 1962 U. ILL. L.F. 663 (1963). The author of the Note from the Illinois Law Forum concluded that the donor should be taxable for the same reasons as Eustice. The author expressed concern over the tax abuse possibilities that would be available after *Teschner*. He hypothesized that an employer could set up a salary structure where an employee received only part of his normal salary. An additional amount would be paid to a person designated by the employee, provided that this amount could never be paid to the employee. Under the rule of *Teschner*, the employee, who performed the services to create the right to income, would be able to assign the income because he never had a right to receive it. *Id.* at 666-67.

On the other hand, other commentators have concluded that the taxpayer could not be taxed on income unless he had a right to receive the income himself at some time. *Teschner*, *supra* note 17, at 596; see also Recent Decision, *supra* at 30; Note, *Federal Taxation: Contestant Not Taxable on Prize When Contest Rules Required Assignment*, 48 MINN. L. REV. 815, 820 (1964) [hereinafter Note, *Contestant Not Taxable*].

The author of that Note expressed the same concern of tax avoidance possibilities as the author from the *Illinois Law Forum*. To mitigate this problem, the author suggested that the *Teschner* rule should only apply where a third party, instead of the donee, prevents the donor from receiving the prize. *Id.* at 821.

178. *Helvering v. Horst*, 311 U.S. 112 (1940).

179. Generally, the donor is not taxable on income if it was uncertain at the time of the gift. See *Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962) (holding that a donor who assigned the rights in a lawsuit before the case was adjudicated was not taxable on the judgement award

Between these two polar opposites lie the cases of assignments of liquidation proceeds and assignments of stock after the declaration of a dividend and before the record date. The next section discusses the latter type of assignment.

C. Assignment of Stock After Declaration Date

According to the traditional assignment of income doctrine, an assignment of property, such as stock, will shift the tax burden to the donee.¹⁸⁰ However, income already earned at the time of the transfer, even if contingent or not absolutely certain to arise, is taxed to the donor.¹⁸¹ Thus, where stock is transferred before a dividend is declared, the donor does not pay the tax on a subsequent dividend.¹⁸² Before declaration, the shareholders have no right to a dividend.¹⁸³ However, where a donor transfers stock after a dividend has been declared, an issue arises as to whether the dividend has been "earned," in which case the dividend would be taxable to the donor.¹⁸⁴

Before corporations started to use a record date, the assignment of stock "with dividend" was treated no differently than any other property¹⁸⁵ in which payment occurred after the right to the payment was fixed and determined.¹⁸⁶

because it was too uncertain at the time of the gift); *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957) (discussed *supra* notes 169-73 and accompanying text); *Morgan Guaranty Trust Co. of N.Y. v. United States*, 585 F.2d 988 (Ct. Cl. 1978) (holding donor not taxable due to uncertainty of income where donor donated the rights to all future payments on Mixed Claims Commission awards which were paid by Germany to the Commission to compensate for property confiscated during World War I); *Dodge v. United States*, 443 F. Supp. 535 (D. Or. 1977) (holding donor who assigned to his daughter the right to receive one half of his brother's estate was not taxable on income from the estate because the donor's claim was too uncertain); Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-8202; Fed. Tax Serv. (MB) § A:4.107.

180. See *supra* note 73.

181. See *supra* note 80.

182. *E.g.*, *Marshall v. Commissioner*, 57 F.2d 633 (6th Cir. 1932). Prior to the declaration of a dividend, this situation is analogous to the transfer of income-producing property.

183. *Eisner v. Macomber*, 252 U.S. 189 (1920); 7 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 141.04[3], at 141-52 (rev. perm. ed. 1989); 18B AM. JUR. 2D *Corporations* § 1204 (1985). The decision of whether to declare a dividend is at the discretion of the corporation's board of directors. Shareholders have no legal right to net profits or accumulated earnings until a dividend is declared.

184. The donor remains taxable for any previously earned income even if he transfers the income-producing property itself. *E.g.*, *Estate of Holmes v. Commissioner*, 1 T.C. 508, 511-12 (1943) (ruling that the *Horst* doctrine applies even if the income-producing property is transferred because the income is already realized; donor essentially is transferring a "tree" with ripe "fruit"). Thus, in *Caruth*, if the dividend is considered "earned" on the declaration date, then the donor is taxed on it even if he transfers the stock itself.

185. Many other types of property produce income that is payable after it is earned. For example, the interest on a bond is earned daily but is not payable until a future date. *E.g.*, *Helvering v. Horst*, 311 U.S. 112 (1940). A court judgement is earned when the judgement occurs but is payable at a future date. *E.g.*, *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945). In all of these situations, the donor cannot avoid paying tax on the imminent payment by assigning the property before payment.

186. Rev. Rul. 74-562, 1974 C.B. 28.

Where no record date exists, the declaration date controls over the actual payment date with regard to when the income is earned.¹⁸⁷ The declaration of a dividend creates a debtor/creditor relationship between the corporation and its stockholders.¹⁸⁸ Therefore, after the declaration date, the corporation could not revoke the dividend.¹⁸⁹ The declaration of the dividend created the right to receive the dividend, which thereafter was separate from the stock.¹⁹⁰ Thus, the stockholder holding the stock on the declaration date, as opposed to the payment date, was taxed on the dividend.¹⁹¹ The theory was that on the declaration date the corporation set aside assets to pay for the dividend by recognizing the liability on its accounting records. Furthermore, once established, the debt continued in existence regardless of any future actions by the corporation.¹⁹² Thus, by declaring a dividend, the corporation created a liability owed to the shareholders and severed an interest in the "earnings and profits" of the corporation.¹⁹³ As a result, the stockholder had a fixed and absolute right to the dividend.¹⁹⁴ Under the assignment of income doctrine, if the stockholder

187. *Estate of Crellin v. Commissioner*, 17 T.C. 781 (1951), *aff'd sub. nom.* *Crellin's Estate v. Commissioner*, 203 F.2d 812 (9th Cir. 1953). In *Estate of Crellin*, the corporation declared a dividend with no record date. The court held that the dividend vested on the declaration date. *Id.* at 782; *see also* 7 Z. CAVITCH, *supra* note 183, § 141.04[3] (same); Note, *supra* note 25, at 437-38 (same).

Both parties in *Caruth* agreed that in the absence of a record date, the right to the dividend is created on the declaration date. Reply Brief for the Appellant at 6, *Caruth v. United States*, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015).

188. *Chesapeake & Delaware Canal Co. v. United States*, 250 U.S. 123, 126 (1919); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 126 (2d Cir. 1956); *Commissioner v. Goldwyn*, 175 F.2d 641 (9th Cir. 1949); *Commissioner v. Cohen*, 121 F.2d 348 (5th Cir. 1941); *Lamberth v. Commissioner*, 120 F.2d 101 (9th Cir. 1941); *Commissioner v. T.C. Miller Mill Co.*, 102 F.2d 599 (5th Cir. 1939); *United States v. Southwestern Portland Cement Co.*, 97 F.2d 413 (9th Cir. 1938); *Commissioner v. Scatena*, 85 F.2d 729, 731 (9th Cir. 1936); *United States v. Guinzburg*, 278 F. 363 (2d Cir. 1921); *McKelvy v. United States*, 478 F.2d 1217, 1234 (Ct. Cl. 1973) (Skelton, J., dissenting); *Bulgar Block Coal Co.*, 48 F.2d 675 (Ct. Cl. 1931); *Caleb & Co. v. E.I. DuPont de Nemours & Co.*, 615 F. Supp. 96 (S.D.N.Y. 1985); *First Nat'l Bank & Trust Co. v. Glenn*, 36 F. Supp. 552 (W.D. Ky. 1941); Rev. Rul. 75-554, 1975-2 C.B. 478; Rev. Rul. 69-130, 1969-1 C.B. 93; 7 Z. CAVITCH, *supra* note 183 § 141.04[3]; 11 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5365 (rev. perm. ed. 1986); 18B AM. JUR. 2D *Corporations* § 1224 (1985); Note, *Rights in Ordinary Corporate Dividends: Significance of Date of Closing Transfer Books*, 38 HARV. L. REV. 245 (1924).

189. *Crellin's Estate v. Commissioner*, 203 F.2d 812 (9th Cir. 1953); *McKelvy v. United States*, 478 F.2d 1217, 1234 (Ct. Cl. 1973) (Skelton, J., dissenting); *Caleb & Co. v. E.I. Dupont de Nemours & Co.*, 615 F. Supp. 96 (S.D.N.Y. 1985); 7 Z. CAVITCH, *supra* note 183, § 141.04[3]; Note, *supra* note 188, at 247-49.

190. 11 W. FLETCHER, *supra* note 188, § 5365; 18B AM. JUR. 2D *Corporations* § 1224, at 124 (1985).

191. *See supra* note 73.

192. 18B AM. JUR. 2D *Corporations* § 1208 (1985).

193. Note, *When Do Dividends Vest?*, 27 GEO. L.J. 74 (1938).

194. *Wheeler v. Northwestern Sleigh Co.*, 39 F. Supp. 347, 349 (E.D. Wis. 1889). The *Wheeler* court stated:

The earnings represented by the dividend . . . become a debt of the company to the individual who at the time of the declaration of the dividend was the owner of the

assigned stock after he already had the right to receive the dividend, he was taxed on the dividend income.¹⁹⁵ The situation is no different than a donor who assigns a bond after a coupon has become due but before it is paid,¹⁹⁶ or a donor who assigns a court judgment after the judgment but before it is paid.¹⁹⁷

The general practice today is for the corporation to establish a record date.¹⁹⁸ The record date was established for the administrative convenience and protection of the corporation.¹⁹⁹ As long as the corporation paid the owner registered on its records, the corporation could not be sued for failing to pay the rightful owner of the dividend.²⁰⁰ Thus, corporations pay dividends to the stockholders of record on a date between the declaration date and the payment date.²⁰¹

If the donor transfers the stock with dividend after the declaration and record date but before payment, then the donor is taxable on the dividend.²⁰² Because the donor has a right to the dividend, he cannot escape the tax by assigning the right to receive the dividend before it becomes due.²⁰³ Since the donor donated the stock after both the declaration and record dates he therefore had a right to receive the dividend. These cases present no real analytical problems.²⁰⁴

stock. That the dividend is payable at a future date can work no distinction in the right. The debt exists from the time of the declaration of the dividend, although payment is postponed for the convenience of the company. The right became fixed and absolute by the declaration. This right could, of course, be transferred with the stock by special agreement, but not otherwise. The dividend would not pass as an incident of the stock.

Id. (quoted in 7 Z. CAVITCH, *supra* note 183, § 141.04[3]). *Accord* McGlue's Estate v. Commissioner, 119 F.2d 167, 171 (4th Cir. 1941). *See also* 18B AM. JUR. 2D Corporations § 1224 (1985); 11 W. FLETCHER, *supra* note 188, § 5377.

195. Rev. Rul. 74-562, 1974-2 C.B. 28 (holding donor taxable on stock transferred after declaration date, which was also record date, but before payment date).

196. *Helvering v. Horst*, 311 U.S. 112 (1940).

197. *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945). In *Doyle*, a taxpayer attempted to assign a court judgment after an appeal was denied but before it was paid. The court held that the donor was liable for the tax because he had a vested right to receive the judgement. *Id.* at 771.

198. *E.g.*, *Caleb Co. v. Commissioner*, 615 F. Supp. 96 (1985).

199. *Id.* (citing Note, *supra* note 25, at 437-39); *First Nat'l Bank & Trust Co. v. Glenn*, 36 F. Supp. 552 (W.D. Ky. 1941); 18B AM. JUR. 2D Corporations § 1237 (1985); Note, *supra* note 188, at 246-47; 7 Z. CAVITCH, *SUPRA* note 183, § 142.11[2].

200. 18B AM. JUR. 2D Corporations § 1235 (1985).

201. *Id.*

202. Rev. Rul. 74-562, 1974-2 C.B. 28. In Rev. Rul. 74-562, a donor donated stock after the declaration date, which was also the record date to a charity. The IRS ruled that the donor was taxable on the dividend under the reasoning of *Horst*. *Id.*; *see also* Rev. Rul. 82-11, 1982-1 C.B. 51. In Rev. Rul. 82-11, a shareholder bought stock after the record date but before the ex-dividend date. The ex-dividend date is the date under stock exchange rules at which time the buyer is no longer entitled to the dividend. Despite the stock exchange rules, the IRS ruled that the seller, not the buyer, was taxable on the dividend. *Id.* at 52.

203. This is an application of the *Horst* doctrine.

204. This rule is not changed by stock exchange rules determining who is entitled to receive the dividend. Rev. Rul. 82-11, 1982-1 C.B. 51. In Rev. Rul. 82-11, a shareholder sold stock after the

Similarly, the case of a *sale* of stock between the declaration and record dates is well settled. Treasury Regulation 1.61-9(c) provides that the buyer in this situation is taxable on the dividend rather than the seller.²⁰⁵ The rationale for this rule is logical since the seller realizes the proceeds of the sale at the time of the sale. This rule prevents the seller from being taxed on both the dividend and the sale proceeds. The seller pays tax based on the stock proceeds, which includes the value attributable to the dividend in the year in which the sale occurred.²⁰⁶ Thus, the regulation provides certainty in the complex area of traded securities.²⁰⁷

The issue that arose in *Caruth Corp. v. United States* dealt with a gift of stock "with dividend" after the declaration date but before the record date. Originally, dividends were considered accrued and absolute on the declaration date, even where a record date existed.²⁰⁸ Since the declaration of a dividend creates a debtor/creditor relationship in most states,²⁰⁹ the right to receive the dividend arose on the declaration date. For example, in *Helvering v. McGlue's Estate*,²¹⁰ the shareholder died after the declaration date but before the record

record date but before the "ex-dividend" date. Under stock exchange rules, the buyer was entitled to the dividend if he bought the stock before the ex-dividend date. Usually, the ex-dividend date is four days before the record date, but if the dividend exceeds fourteen percent of the stock, as was the case here, postponement is possible. Despite the stock exchange rules to the contrary, the IRS ruled that the seller was taxable on the dividend. *Id.* at 52. The private contract between the parties which stated that the buyer was entitled to receive the dividend was not controlling. See also *Silco v. United States*, 779 F.2d 282 (5th Cir. 1986) (the court stated that it would follow Rev. Rul. 82-11 in future cases).

Similarly, if the record date is prior to the declaration date, then a right to the dividend is created on the declaration date. Thus, the holder of the stock on the declaration date is taxable on the dividend. For example, in *Walker v. Commissioner*, 544 F.2d 419 (9th Cir. 1976), the corporation declared a dividend on October 24, 1964, payable to all shareholders of record on September 30, 1964. A shareholder sold his shares after the declaration date. The court held the seller taxable on the dividend because he held the stock on the declaration date, the date the right to the dividend was created. *Id.* at 442. *Accord* *Gilmore v. Commissioner*, 25 T.C. 1321 (1956). The corporation declared dividend on December 12, 1949 to shareholders of record on November 26, 1949. When a shareholder sold shares after the dividend was declared, the court held that the seller was taxable on the dividend because he held the stock on the declaration date. *Id.* at 1325.

205. Treas. Reg. 1.61-9(c) (as amended 1964). This Regulation provides in relevant part that "[w]hen stock is sold between the time of declaration and the time of payment of the dividend, and the dividend takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him." *Id.*

206. B. BITTKER & J. EUSTICE, *supra* note 72, ¶ 7.07, at 7-46.

207. *Id.* (stating that "[t]his approach . . . seems largely a matter of administrative convenience").

208. *Commissioner v. Cohen*, 121 F.2d 348 (5th Cir. 1941); *Lamberth v. Commissioner*, 120 F.2d 101, 105 (9th Cir. 1941); *Helvering v. McGlue's Estate*, 119 F.2d 167 (4th Cir. 1941); *First Nat'l Bank & Trust Co. v. Glenn*, 36 F. Supp. 552 (W.D. Ky. 1941); *Ledyard v. Commissioner*, 44 B.T.A. 1056 (1941).

209. See *supra* note 188 and accompanying text. In some states, however, the declaration of the dividend does not create a corporate liability. *Richter & Co. v. Light*, 97 Conn. 364, 116 A. 600 (1922). In *Richter*, the court held that the debt arises at the record date. See *infra* notes 228-30 and accompanying text.

210. 119 F.2d 167 (4th Cir. 1941)

date. Section 42 of the Tax Code provided that amounts accrued at the time of death were included in the decedent's final tax return.²¹¹ The court held that stock dividends accrued on the declaration date and thus were includible in the decedent's final return.²¹² The court's decision was based on the fact that under state law, the declaration of a dividend created a separate, vested right²¹³ to the dividend in favor of the shareholder.²¹⁴ This was true despite the fact that the state statute provided that "only stockholders of record at the time [of the record date] shall be entitled to receive such dividend."²¹⁵ The court read this language to mean only that the purpose of the record date was to protect the corporation where it paid the dividend to the stockholder registered on the corporation's books on the record date.²¹⁶ The court did not read the statute to mean that the dividend accrued on the record date.

In 1945, however, the Supreme Court ruled in *Estate of Putnam v. Commissioner*²¹⁷ that dividends do not accrue on the declaration date.²¹⁸ The facts were identical to *McGlue's Estate*: the shareholder died after the declaration date but before the record date.²¹⁹ Again section 42 of the Tax Code provided that amounts accrued at the time of death were included in the decedent's final tax return.²²⁰ The Court held that the dividend did not accrue on the declaration date because the distributee was not fixed and determined.²²¹ The Court left open whether the dividend accrued on the record date, payment date, or the date of receipt by the shareholder.²²² The Court found that a

211. *Id.* at 169.

212. *Id.* at 172.

213. "Vested right" means an absolute, unconditional present right to present or future enjoyment that does not depend on an uncertain event. A person has a vested right if it cannot be divested from him without his consent. BLACK'S LAW DICTIONARY 1402 (5th ed. 1979). Normally, income is earned at the same time the right to income is vested and accrued. In certain situations, however, such as the assignment in the subject opinion, these three concepts are not necessarily simultaneous. Treas. Reg. § 1.461-1(a)(2) (1957). However, all events cannot occur before economic performance occurs. I.R.C. § 461(h) (1988).

214. *McGlue's Estate*, 119 F.2d at 171; *accord* *Commissioner v. Cohen*, 121 F.2d 348 (5th Cir. 1941); *Lamberth v. Commissioner*, 120 F.2d 101, 105 (9th Cir. 1941); *First Nat'l Bank & Trust Co. v. Glenn*, 36 F. Supp. 552 (W.D. Ky. 1941); *Ledyard v. Commissioner*, 44 B.T.A. 1056 (1941).

215. *Helvering v. McGlue's Estate*, 119 F.2d 167, 171 (4th Cir. 1941).

216. *Id.*

217. 324 U.S. 393 (1945).

218. *Id.* at 398.

219. *Id.* at 395.

220. *Id.*

221. *Id.* at 399-400.

222. *Id.* at 398. Treasury Regulation 1.301-1(b) subsequently answered the question left open in *Estate of Putnam*. The regulation ruled that dividends accrue on the day of actual receipt by the shareholder. Thus, both cash basis and accrual basis shareholders include the dividend in income when actually received. *See also* *American Light & Traction Co. v. Commissioner*, 156 F.2d 398 (7th Cir. 1946); *Tar Products Corp. v. Commissioner*, 130 F.2d 866 (3d Cir. 1942); *Dynamics Corp. of America v. United States*, 392 F.2d 241 (Ct. Cl. 1968); *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068 (1976). Technically, the rule for the accrual of dividends does not comply with the "all events" test of Treasury Regulation 1.451-1(a) used in determining when

uniform federal rule should determine when income accrues so that accrual and cash basis taxpayers both include the dividend in income at the same time.²²³ The Court acknowledged that the question of when dividends accrue was a separate question from when dividends vest.²²⁴ *Estate of Putnam* dealt with the question of *when* dividend income should be included in income, but it did not decide *who* should pay the tax.²²⁵

As the court in *McGlue's Estate* indicated, the record date was designed for the administrative convenience of the corporation. However, at the time of *Estate of Putnam*, four states had held that the record date is the date on which the dividend vests.²²⁶ This means that the shareholder actually owning the stock, not necessarily the shareholder on the corporate books, on the record date is entitled to receive the dividend.²²⁷ The Connecticut Supreme Court, in *Richter & Co. v. Light*,²²⁸ created the so-called "Connecticut Rule." The court held that the dividend vests on the record date because, under Connecticut law, that is the date on which a debtor/creditor relationship is created.²²⁹ The court stated that the corporation was free to choose the date on which the corporation's liability should begin.²³⁰

The relationship between state and federal tax law was explained in *Aquilino v. United States*.²³¹ The Supreme Court ruled that state law determined the nature and extent of the taxpayer's property rights while federal tax law attached tax consequences to those rights.²³² Thus, even though under state law the assignments in *Lucas* and *Horst* were valid and the donees were entitled to receive the income, the donor was still held taxable under federal tax laws.²³³ As applied to the assignment of stock in cases such as *Richter*, state law determines whether the assignment is valid, who is entitled to the dividend, and when the corporation incurs a liability to the shareholders; federal tax law determines whether the donor's rights at the time of the gift are

income accrues. Gen. Couns. Mem. 37,327 (Nov. 18, 1987). The rule is, therefore, seen as promoting a uniform rule for both cash and accrual method taxpayers.

223. *Estate of Putnam v. Commissioner*, 324 U.S. 393, 396 n.3 (1945).

224. *Id.*

225. See *Estate of Smith v. Commissioner*, 292 F.2d 478, 480 (3d. Cir. 1961), *cert. denied*, 368 U.S. 967 (1962). The court distinguished *Estate of Putnam* in this manner.

226. *Smith v. Taecker*, 133 Cal. App. 351, 24 P.2d 182 (1933); *Richter & Co. v. Light*, 97 Conn. 364, 116 A. 600 (1922); *Ford v. Ford Mfg. Co.*, 22 Ill. App. 76, 84 (1921); *Nutter v. Andrews*, 246 Mass. 224, 142 N.E. 67 (1923); see *Estate of Putnam*, 324 U.S. at 396 n.3.

227. 7 Z. CAVITCH, *supra* note 183, § 141.04[3] (stating that when the "transfer takes place after the dividend is declared and the purchaser is not registered as the record owner on the record date, the common law rule is that these dividends belong to the buyer").

228. 97 Conn. 364, 116 A. 600 (1922).

229. *Id.* at 370-71, 116 A. at 603.

230. *Id.* at 370, 116 A. at 602-03.

231. 363 U.S. 509 (1960).

232. *Id.* at 512-13; see also *Estate of Smith v. Commissioner*, 292 F.2d 478, 479 (3d. Cir. 1961), *cert. denied*, 368 U.S. 967 (1962); Rev. Rul. 75-554, 1975-2 C.B. 478.

233. *Helvering v. Horst*, 311 U.S. 112, 115 (1940); *Lucas v. Earl*, 281 U.S. 111, 114 (1930).

sufficient to hold him taxable.²³⁴

Several other states have adopted the Connecticut Rule that dividends vest at the record date.²³⁵ Although these states adopted the *Richter* court's conclusion, they failed to consider the underlying rationale of *Richter*. The courts in these jurisdictions did not base their decisions on the fact that a debtor/creditor relationship is created on the record date.²³⁶ Nevertheless, they held that a dividend vests on the record date, despite the fact that under state law a debtor/creditor relationship was formed on the declaration date. In these states, a dividend vests on the record date even though a corporate liability is created on the declaration date.²³⁷

In sum, the general rule in most states, for both sales and gifts, is that a corporation avoids liability for the dividend if it pays the shareholder of record on the record date.²³⁸ However, the actual owner of the stock on the record date is entitled to receive the dividend, even if he is not registered on the corporate books.²³⁹ As a result, if the transferor is registered on the corporation's records and the transferee is the actual owner on the record date, then the transferor must transfer the dividend (which he will receive) to the transferee.²⁴⁰

The only case which has addressed the issue of a gift of stock after the declaration date but before the record date is *Estate of Smith v. Commissioner*.²⁴¹ In *Estate of Smith*, a controlling shareholder donated stock to his

234. *Blair v. Commissioner*, 300 U.S. 5, 12 (1937); *United States v. Shafto*, 246 F.2d 338, 343 (1957); Rev. Rul. 75-554, 1975-2 C.B. 478.

235. See Rev. Rul. 75-554, 1975-2 C.B. 478; Priv. Ltr. Rul. 7209281850A (Sept. 28, 1972); Note, *supra* note 193, at 76 (discussing those states which apply the Connecticut Rule); Note, *supra* note 25, at 438 (same).

236. In these states, the debtor/creditor relationship still is created on the declaration date. See Rev. Rul. 75-554, 1975-2 C.B. 478; Priv. Ltr. Rul. 7209281850A (Sept. 28, 1972).

237. See Rev. Rul. 75-554, 1975-2 C.B. 478; Priv. Ltr. Rul. 7209281850A (Sept. 28, 1972).

238. 7 Z. CAVITCH, *supra* note 183, § 141.04[3] ("the corporation has the right to pay the dividend to the holder of record on the record date"); 11 W. FLETCHER, *supra* note 188, § 5377 (stating that when a record date is set, "the corporation may safely pay the shareholder of record on that date").

239. 7 Z. CAVITCH, *supra* note 183, § 141.04[3] (stating that when the "transfer takes place after the dividend is declared and the purchaser is not registered as the record owner on the record date, the common law rule is that these dividends belong to the buyer").

240. *Id.* § 141.04[3] (stating that "[w]hile the corporation has the right to pay the dividend to the holder of record on the record date, such holder might be required to pay it over to a transferee" if he is the actual owner on the record date).

241. 292 F.2d 478 (3d. Cir. 1961), *cert. denied*, 368 U.S. 967 (1962). *Bishop v. Shaughnessy*, 195 F.2d 683 (2d Cir. 1952), is sometimes cited for the proposition that the donee, rather than the donor, is taxed on gifts of stock made after the declaration date but before the record date. However, *Bishop* is not good authority for this proposition because in that case, the corporation did not set a record date. The donor donated stock after the corporation passed a resolution authorizing the treasurer to distribute at his discretion back dividends accumulated on cumulative stock. Significantly, the resolution did not fix a record or payment date. The court found that no legally enforceable right to the dividend arose at the date of the resolution. *Id.* at 685. Since the resolution was too indefinite, it was not the equivalent of the declaration of a dividend. *Id.* Recall that where no record date exists, the right to the dividend is created on the declaration date rather

children after the declaration date but one day before the record date. The court first determined that under New Jersey law a dividend vested as of the declaration date. The taxpayers argued that this rule was inapplicable where the corporation establishes a record date. However, the court ruled that the right to the dividend had sufficiently vested on the declaration date.²⁴² In applying the *Horst* doctrine, the court concluded that since the donor had a right to the dividend as of the declaration date, he could not escape the tax by assigning the dividend, along with the stock, to his children.²⁴³ Thus, the court held that the dividend income was taxable to the donor. The court found *Estate of Putnam* distinguishable because that case dealt with *when* income is accrued for purposes of inclusion in a decedent's tax return, while the case before it dealt with *who* earned the income.²⁴⁴

D. Substance Over Form Doctrine

The IRS has from time to time resorted to the substance over form doctrine.²⁴⁵ In its general application, this doctrine operates to give effect to the economic realities of a transaction rather than the form in which it is cast.²⁴⁶ The Supreme Court stated, in *Commissioner v. Court Holding Co.*,²⁴⁷ that "[t]o permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."²⁴⁸

This doctrine has been applied to the assignment of stock in different con-

than the payment date. See *supra* note 184 and accompanying text.

242. *Estate of Smith*, 292 F.2d at 480. The court stated that "'the fruit had ripened' before the gift." *Id.*

243. *Id.* at 479.

244. *Id.* at 480. The court explained that *Estate of Putnam* and its progeny indicate merely that, even if the parents here had themselves retained the stock and received the dividends they would properly have accounted for this income in the year of distribution rather than the year of declaration But such determination of the proper time does not help solve the present problem, whether the donor or donee of the right to the dividend is the person legally required to pay the tax upon it.

Id.

245. *Knetsch v. United States*, 364 U.S. 361, 365-66 (1960) (holding a transaction was a sham between taxpayer and insurance company which resulted in impermissible deductions and tax avoidance); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (holding that a sale by stockholders of property conveyed in the form of a liquidating dividend was really sale by corporation); *Higgins v. Smith*, 308 U.S. 473, 477 (1940) (holding that a taxpayer cannot deduct a loss from sale of securities made to a corporation wholly owned by taxpayer); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185, 1192 (5th Cir. 1970) (holding that a corporation impermissibly disguised a portion of sale price as an intercompany dividend), *cert. denied*, 401 U.S. 939 (1971); see also Rev. Rul. 89-102, 1989-35 I.R.B. 8.

246. The Fifth Circuit in *Waterman Steamship Corp. v. Commissioner*, 430 F.2d at 1192, stated that tax consequences must turn upon the economic substance of a transaction and not upon the form of the transaction.

247. 324 U.S. 331 (1945).

248. *Id.* at 334.

texts. For example, in *Rollins v. United States*,²⁴⁹ a shareholder elected to exercise his option to purchase the shares of the taxpayer.²⁵⁰ The buying shareholder deposited five percent of the purchase price in an escrow account and agreed to pay the balance several months later. After the buyer exercised his option to buy the shares but before the sale was finally closed, the taxpayer donated his stock to a charity.²⁵¹ Even though the taxpayer's right to receive income was contingent on the buyer paying the full purchase price, the court found that the sale was virtually certain to be closed.²⁵² By looking at the substance of the transaction, the court ruled that the assignment of income doctrine required the taxpayer to be taxed on the proceeds of the sale.²⁵³ The court concluded that in reality the donor donated income realized from the sale to the charity.²⁵⁴

Similarly, in *Overton v. Commissioner*,²⁵⁵ the controlling shareholders of a corporation directed the corporation to reorganize the common stock into two classes, Class A and Class B.²⁵⁶ The Class B stock had limited voting power and liquidating value, but had a residual share in any excess dividends that remained after Class A stock was paid.²⁵⁷ The controlling shareholders donated the Class B stock to their spouses.²⁵⁸ The dividend distributed on the Class B stock was approximately double that paid on the Class A stock for the year in question.²⁵⁹ The court ruled that although in form the shareholders made a gift of stock, in substance they assigned part of their future dividends to their spouses while retaining effective control over the income-producing property.²⁶⁰ Thus, the court held the donors liable for the tax burden.²⁶¹

249. 302 F. Supp. 812 (W.D. Tex. 1969).

250. *Id.* at 814. Two groups of shareholders of a closely-held corporation were in dispute. To resolve the dispute the two groups negotiated a "buy and sell" agreement where the minority shareholder could elect to either sell all of his shares to the majority group or buy all the shares from the majority group. *Id.* The minority shareholder elected to buy all the stock from the majority group.

251. *Id.* at 815.

252. *Id.* at 818.

253. *Id.*

254. *Id.* Both charities sold the shares they had received to the shareholder who had purchased the taxpayer's shares.

255. 162 F.2d 155 (2d Cir. 1947).

256. *Id.* at 156.

257. *Id.* Class A stock was to receive a ten dollar per share dividend before any payments were made to Class B stock. Any excess dividends that remained after the payment to the Class A stock were to be shared in a ratio of one-fifth for Class A stock and four-fifths for Class B stock. *Id.*

258. *Id.*

259. *Id.*

260. *Id.*

261. *Id.*; see also *Babson v. Delany*, 51 A.F.T.R. 1346 (D. Mass. 1956). In *Babson*, a controlling shareholder issued a new class of stock to his wife under the color of a sale. The dividends on the new class by far exceeded those on the other classes. The court held the donor taxable because the sale in reality was a gift and dividends paid on the new class of stock was in reality an assignment of income. *Id.* at 1347-48.

The common element in all these cases applying the substance over form doctrine is that a taxpayer who owned the stock when the right to income arose cannot escape the taxation by a formal arrangement "however skillfully devised" that attempts to shift the tax to another. The court in *Caruth Corp. v. United States*²⁶² was asked to decide if the taxpayer's formal arrangement was in substance an attempt to assign income already earned.

II. CARUTH CORP. v. UNITED STATES

A. Facts

A taxpayer owned a seventy-five percent controlling interest in both the common voting and nonvoting stock of a Texas corporation.²⁶³ He also owned one hundred percent of the preferred nonvoting stock.²⁶⁴ The remaining shares were owned by the taxpayer's two nephews.²⁶⁵ The corporation was successful²⁶⁶ and had accumulated substantial earnings in its twenty-five year history, during which the corporation never paid out a dividend.²⁶⁷ Since the taxpayer planned to wind down the activities of the corporation, he was seeking to "get money out of" the corporation.²⁶⁸ The taxpayer also wanted to buy his estranged nephews' shares but they refused, and he hoped to entice them to sell the stock by declaring a substantial dividend.²⁶⁹ To accomplish these results, the taxpayer directed the corporation to declare a dividend on May 8, 1978 payable on May 17 to shareholders of record on May 15.²⁷⁰

One day after the declaration date but prior to the record date, the taxpayer donated 1,000 shares of his preferred nonvoting stock to a charity.²⁷¹ He designated that his donated shares be placed into a fund bearing his name.²⁷² Prior to the dividend, each share of stock had a value of \$100.²⁷³ After the declaration of the dividend, the value of the stock increased by \$1,500, the amount of the dividend, to \$1600.²⁷⁴ The taxpayer claimed a charitable deduction for the

262. 865 F.2d 644 (5th Cir. 1989).

263. *Id.* at 646.

264. *Id.* The preferred stock was callable at \$100 per share, with thirty days notice. *Id.* at 645.

265. *Id.* at 646.

266. *Id.* at 645.

267. *Id.* at 647.

268. *Id.*

269. *Id.*

270. *Id.* The dividend was in the amount of \$1,500 per share.

271. *Id.*

272. *Caruth Corp. v. United States*, 688 F. Supp. 1129, 1131 n.6 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989).

273. Since the stock was callable at \$100, the value of the stock could not be more than \$100. Brief for Appellant at 10 n.8, *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015). Also, the value of the stock with the dividend was \$1600 per share, which included the \$1500 dividend. *Caruth*, 865 F.2d at 648. This establishes that the value of the stock before the dividend was \$100.

274. 865 F.2d at 648.

fair market value of the stock, \$1,600,000,²⁷⁶ almost all of which was attributable to the \$1,500,000²⁷⁶ dividend. However, the taxpayer did not include any of the dividend in income because he was not the shareholder of record on May 9.²⁷⁷

Two months later, the charity that had received the stock asked the taxpayer if he knew of anybody that would be willing to buy the stock.²⁷⁸ Nine months later, the taxpayer told the charity that he could not find a buyer but that he would buy the stock back himself for \$100 per share. The charity sold the stock back to the taxpayer for \$100 per share.²⁷⁹

The IRS imposed a tax deficiency on the taxpayer for the amount of the dividend.²⁸⁰ The taxpayer paid the amount under protest and filed suit for refund of the taxes paid under protest.²⁸¹

The IRS conceded the legitimacy of the deduction, but argued that the taxpayer had to include the amount of the \$1,500,000 dividend in income. According to the assignment of income doctrine, the dividend was earned while in the taxpayer's hands.²⁸² The IRS treated the dividend as being a separate asset apart from the stock. It argued that the taxpayer diverted some of his income into preferred stock by declaring a dividend that raised the value of the stock. He then gave away the stock "pregnant" with dividend.²⁸³ This had the effect of shifting the income of the taxpayer to the tax-exempt charity.²⁸⁴

The taxpayer responded that the stock and dividend were one indivisible appreciated asset, and since he gave away that asset without realizing the income, he should not have had to pay tax on the dividend.²⁸⁵

B. Court's Holding

The district court held that the taxpayer was not taxable on the dividend paid to the charity.²⁸⁶ The court relied primarily on *Estate of Putnam* to find that the taxpayer had no vested right in the dividend until the record date.²⁸⁷

275. This figure is the result of the following calculation: \$1600 per share x 1000 shares. As a result of the restrictions on charitable deductions imposed by § 170(b)(1), the taxpayers were only allowed to deduct \$404,775 of the \$1,600,000 contribution on their 1978 tax return. The remaining contribution was carried over to subsequent years. The taxpayer was allowed to deduct \$844,609 in 1979, \$250,101 in 1980, and \$100,515 in 1981. Brief for Appellant at 6 n.6, *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015).

276. This figure is the result of the following calculation: \$1500 per share x 1000 shares.

277. *Caruth*, 865 F.2d at 648.

278. *Id.* at 647.

279. *Id.* at 647-48.

280. *Id.* at 648.

281. *Id.*

282. *Id.* at 646.

283. *Id.* at 649.

284. *Id.*

285. *Id.* at 646.

286. *Caruth Corp. v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989).

287. *Id.* at 1133. The court found that the "leading case concerning a gratuitous assignment of

According to the court, the taxpayer had merely transferred an appreciated asset and, under *Blair v. Commissioner*, the transfer of an entire interest in property shifts the tax burden on future income to the donee.²⁸⁸ The court distinguished the liquidation cases²⁸⁹ on the basis that those cases concerned shareholders who acquired an absolute and unqualified right to the liquidation proceeds when the plan of liquidation was adopted.²⁹⁰

The Second Circuit affirmed the district court's decision.²⁹¹ The court ruled that the taxpayer merely gave away an asset that had appreciated in value, rather than an asset (stock) accompanied by earned income (dividends).²⁹² The court found that pursuant to both Texas law and federal tax law, a dividend does not vest until the record date.²⁹³ Since the taxpayer gave away the asset before the record date, he did not have to include the dividend in income.

The court began its analysis stating that "[i]n general, dividend income is taxed to the shareholder who, on the record date, owns the stock with respect to which dividends are paid and who is entitled to receive the dividend."²⁹⁴ The court relied on *Estate of Putnam* for this general proposition. Therefore, according to the court, the IRS must find some exception to the rule in order to tax the donor on the dividend.²⁹⁵ The court determined that neither the assignment of income doctrine nor the substance over form doctrine applied in this case.²⁹⁶

1. Assignment of Income Doctrine

The court ruled that the assignment of income doctrine did not apply. The court reasoned that the taxpayer never enjoyed any legal right to the dividend because this right does not occur until the record date.²⁹⁷ Since the taxpayer gave away the income-producing property (the stock), he was no longer liable for the tax on the future dividend. The charity earned the income because it received the dividend. With respect to Texas state law, the court relied solely on the corporate statute that allows a corporation to establish a record date that determines who is entitled to receive the income.²⁹⁸ The court read this statute as support for the proposition that a dividend vests on the record date.

dividend income is *Estate of Putnam*." *Id.* (citation omitted).

288. *Id.* at 1134; see *supra* note 71 (discussing *Blair v. Commissioner*).

289. *Caruth*, 688 F. Supp. at 1135-36 (referring to *Dayton Hydraulic Co. v. United States*, 592 F.2d 937 (6th Cir. 1979); *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972)); see *supra* notes 117-46 and accompanying text (discussing the liquidation cases).

290. *Caruth*, 688 F. Supp. at 1136.

291. *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989).

292. *Id.* at 651.

293. *Id.* at 649.

294. *Id.* at 648.

295. *Id.*

296. *Id.*

297. *Id.*

298. *Id.* (citing TEX. BUS. CORP. ACT ANN. art. 2.26(A) (Vernon 1980 & Supp. 1990)).

The court distinguished *Estate of Smith* on the grounds that, under the state law in that case, a dividend explicitly vested on the declaration date.²⁹⁹

With respect to federal tax law, the court relied on both Revenue Ruling 82-11 and *Estate of Putnam* in support of the proposition that the dividend vested on the record date.³⁰⁰ Revenue Ruling 82-11 held that the shareholder on the record date is entitled to receive the dividend.³⁰¹ *Estate of Putnam* held that a dividend does not accrue on the declaration date because the shareholder did not have a fixed and determined right to the dividend.³⁰²

2. Substance Over Form

The court also rejected the substance over form doctrine.³⁰³ The IRS offered several arguments in support of its position. It first argued that there was no legitimate business purpose for a closely held corporation with only three shareholders to set a record date.³⁰⁴ The court disagreed. The district court found that a valid business purpose existed in that the taxpayer wanted to encourage his nephews to sell their stock.³⁰⁵ The time period between the declaration and record dates gave the nephews an opportunity to sell the stock and realize capital gain rather than ordinary dividend income.³⁰⁶ The court found clear supports for these findings and, therefore, affirmed them.³⁰⁷

The court also rejected the IRS's other arguments. The court dismissed as irrelevant the fact that the taxpayer had control over the corporation,³⁰⁸ that the corporation had a right to redeem the preferred shares,³⁰⁹ and that the taxpayer eventually bought back the stock from the charity.³¹⁰

The court, therefore, held that the general rule applied: a dividend vests on the record date. Since the IRS did not prove an exception to the rule, the taxpayer was not required to pay tax on the dividend.

299. *Id.*; see supra notes 241-44 and accompanying text (discussing *Estate of Smith*).

300. *Caruth Corp. v. United States*, 865 F.2d 644, 648 (5th Cir. 1989).

301. Rev. Rul. 82-11, 1982-1 C.B. 51, 52 ("shareholder does not become entitled to a dividend . . . until the record date").

302. *Estate of Putnam v. Commissioner*, 324 U.S. 393, 396 (1945).

303. *Caruth*, 865 F.2d at 650.

304. *Id.*

305. *Id.* The taxpayer had not been getting along with his nephews and he felt that the corporation would run better if the problems with his nephews could be solved.

306. *Id.*

307. *Id.*

308. *Id.* The court stated that Caruth's control did not deprive the preferred shares of their status as an income-producing asset.

309. *Id.* The court reasoned that since the corporation had to give the shareholders thirty days notice before it could redeem the shares, the taxpayer was powerless to interfere with the charity's right to receive the dividend.

310. *Id.* The court accepted the district court's finding that there had been no repurchase agreement between Caruth and the charity at the time of the donation.

III. ANALYSIS

The court in *Caruth* concluded that the taxpayer transferred an appreciated asset rather than an asset accompanied by earned income.³¹¹ This decision was based on the finding that the right to the dividend arose on the record date.³¹² It emphasized that the taxpayer gave away the "tree," and thus, should be relieved of the tax liability.³¹³ The court, however, failed to adequately analyze who "earned"³¹⁴ the income. It is well settled that the transfer of the income-producing property shifts the tax burden on the future income to the donee.³¹⁵ The focus, however, should be whether the declared dividend constituted earned income which is taxable to the donor/taxpayer.

Determining who earned a dividend is not as straightforward as other areas of tax law. Income from services is earned by the taxpayer who performed the services.³¹⁶ Income from property is usually earned by some specific event that creates the right to the income.³¹⁷ Although a dividend is income from property, there are two possible dates at which time the income might be considered earned: the declaration date and the record date. Two other areas dealing with the transfer of stock, liquidations,³¹⁸ and mergers,³¹⁹ similarly involve two possible times when income could be earned. In both of these situations, the courts have decided that the income from the stock is earned on the earlier date because it is at that time the right to the income arises.

A. Caruth Erroneously Ruled that Dividend is Vested on Record Date

The *Caruth* court based its decision on the erroneous belief that a dividend vests on the record date.³²⁰ The court erred in applying both federal and state law.

The owner of the stock in a corporation has many rights.³²¹ Prior to the declaration of a dividend, however, the shareholder has no right to receive any distribution of profits in the form of dividends. Whereas, once a corporation declares a dividend, a debtor/creditor relationship is created between the cor-

311. *Id.* at 651.

312. *Id.* at 649.

313. *Id.*

314. Recall that income is "earned" if its realization "has become sufficiently proximate in time, or in likelihood, that the donor of the right to receive it cannot escape taxation." See *supra* notes 162-63 and accompanying text; Note, *supra* note 120, at 694 n.64.

315. *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

316. *Lucas v. Earl*, 281 U.S. 111, 115 (1930); see *supra* note 34 and accompanying text.

317. See *Estate of Applestein v. Commissioner*, 80 T.C. 331, 344-45 (1983). The court noted that the "donor remains liable for the tax on income later received by the donee where the occurrence of a specific event with respect to that property creates the right to the income." *Id.*

318. See *supra* notes 117-46 and accompanying text.

319. See *supra* notes 147-53 and accompanying text.

320. *Caruth Corp. v. United States*, 865 F.2d 644, 648 (5th Cir. 1989).

321. For example, the owner of preferred stock may have the right to vote, the right to accumulate unpaid dividends in arrears, the right to convert the stock to common stock, the right to a share of assets upon liquidation, and the right to dividends if and when declared.

poration and each shareholder under the laws of most states.³²² On the declaration date, the corporation records the liability on its books and reduces the amount of retained earnings under general accounting principles.³²³ This divides the corporation's assets into the assets that it will retain, and those that it is bound to pay.³²⁴ Since each shareholder is now in the same position as a creditor, the dividend is irrevocable and must be paid.³²⁵ The *Caruth* court failed to recognize that because the corporation is legally bound to pay the dividend, the right to the dividend is created on the declaration date, and therefore the donor should have been taxed on the dividend.

Generally, the gift of income-producing property shifts the tax burden to the donee under the assignment of income doctrine.³²⁶ Any income already earned at the time of the gift, however, is taxed to the donor even though it is received by the donee.³²⁷ Income, once earned, is taxed to the earner and tax liability cannot be avoided by transferring the income-producing property at the same time. Thus, the question in *Caruth* should not have been, as the court believed, whether the income-producing property was transferred, but rather whether the income had already been earned at the time of the transfer.

Determining when a dividend is "earned" depends upon consideration of two possible dates: the declaration date and the record date. Income from property is generally taxed to the owner of the property once the right to the income is created.³²⁸ Since the right to the dividend is created on the declaration date, the donor in *Caruth* should have been taxed on the dividend. The court claimed that the right to the dividend vested on the record date under both federal income tax law and Texas state law.³²⁹ This assertion, however, fails under analysis.

1. *Caruth Erroneously Ruled that Dividend is Vested on Record Date under Federal Law*

Federal tax law does not create any rights, but rather attaches tax consequences to rights created under state law.³³⁰ Thus, Treasury Regulation 1.61-9(c), which governs the sale of stock, does not mean that the right to the dividend is created on the record date. Instead, this regulation means only that a buyer of stock in between the declaration date and the record date pays tax on the dividend.³³¹ The right to the dividend is created on the declaration date,

322. See sources cited *supra* note 188 and accompanying text.

323. *Commissioner v. Goldwyn*, 175 F.2d 641, 644 (9th Cir. 1949).

324. *McKelvy v. United States*, 478 F.2d 1217, 1234 (Ct. Cl. 1973) (Skelton, J., dissenting) (quoting *Wheeler v. Northwestern Sleigh Co.*, 39 F. 347, 349 (C.C.E.D. Wis. 1889)).

325. See sources cited *supra* note 188. The *Caruth* court conceded that a corporation could not revoke the dividend once declared. 865 F.2d at 650.

326. *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

327. See *supra* note 83 and accompanying text.

328. *Horst*, 311 U.S. at 115.

329. *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989).

330. *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960).

331. *Treas. Reg. § 1.61(9)(c)* (as amended 1964).

but the owner of the stock on that date is not taxed on the dividend if he sells the stock before the record date.³³²

The court inappropriately relied on *Estate of Putnam* to support its position that the right to the dividend is created on the record date.³³³ The *Estate of Putnam* decision involved the question of when the dividend accrues, not when it is earned or who should be taxed on the dividend.³³⁴ The case dealt with the application of section 42 of the Tax Code of 1938, which provided that upon the death of the taxpayer, all amounts "accrued" at his death were included in income on his last tax return.³³⁵ The court held that dividends did not accrue on the declaration date within the meaning of section 42.³³⁶ The court itself conceded that the concept of "accrue" is a separate question from when the right to receive the income is created.³³⁷ As the court in *Estate of Smith* pointed out, *Estate of Putnam* "indicate[d] merely that even if the [donors] . . . had themselves retained the stock and received the dividends they would properly have accounted for this income in the year of distribution rather than the year of declaration."³³⁸

Determining who earned dividend income does not depend on the time at which the dividend accrues. Income is accrued when the right to income is fixed and determined. With regard to dividends, *Estate of Putnam* held that dividends do not accrue on the declaration date because the distributee is not fixed and determined.³³⁹ Treasury Regulation 1.301-1(b) elaborated on *Estate of Putnam* and established that dividends are accrued and taken into income *when they are received* by the shareholder, regardless of the shareholders' method of accounting.³⁴⁰ This means that dividends have not yet accrued even for the period between the record date and payment date since the shareholder does not receive the dividend until the payment date. Under the theory of *Caruth*, a donor who transfers stock with dividend after the record date, but before payment, would not be taxable because the dividend is not yet accrued. The donor, however, clearly is taxed on the dividend for stock transferred during this period, even though the dividend is not yet accrued.³⁴¹ Since it is possible for a taxpayer to be taxable on a dividend even though it has not yet accrued, the time at which the dividend accrues is not a valid basis for determining who earned the income, and therefore, who should pay the tax on it.

Furthermore, *Caruth's* reliance on *Estate of Putnam* is inconsistent with the case law treatment of contingent contracts at death. Since a contingent con-

332. See *supra* notes 202-04 and accompanying text.

333. *Caruth*, 865 F.2d at 649.

334. See *supra* notes 217-225 and accompanying text.

335. *Id.*

336. *Id.*

337. *Estate of Putnam v. Commissioner*, 324 U.S. 393, 396 n.3 (1945).

338. *Estate of Smith v. Commissioner*, 292 F.2d 478, 480 (3d. Cir. 1961), *cert. denied*, 368 U.S. 967 (1962).

339. *Estate of Putnam*, 324 U.S. at 396 n.3.

340. Treas. Reg. 1.301-1(b) (as amended 1979).

341. Rev. Rul. 74-562, 1974-2 C.B. 28.

tract is by definition not fixed and determined until it is complete, it does not accrue until such contingency is satisfied.³⁴² Thus, a contingent contract is not included in the decedent's final tax return because it has not yet accrued.³⁴³ Under the *Caruth* theory, a taxpayer who transfers a contingent contract would not be taxed because the contingent contract has not yet accrued. A taxpayer who donates a contingent contract, however, is clearly taxable on the income.³⁴⁴ Thus, the fact that an item of income is excluded from the decedent's tax return does not mean that the same item of income would escape taxation if the taxpayer had not died but instead transferred the income.

For example, assume that a taxpayer entered into a contingent contract on December 1st of year one that would not be completed until one month later on January 1st of year two. If the taxpayer died on December 15th, the income from the contingent contract would not be included in the decedent's return because, pursuant to *Estate of Putnam*, it would not yet have accrued. However, if instead the taxpayer lived and transferred the contingent contract on December 15th to a donee, then the taxpayer would be taxed on the income from the contract in year two. The fact that the contingent contract accrued on January 1st of year two is irrelevant to determine who is taxed on the income where the taxpayer transferred the contract. Similarly, the fact that dividends do not accrue until their actual receipt should not mean that the donor is relieved of tax liability if he transfers the stock before then.

The court also inappropriately relied on Revenue Ruling 82-11.³⁴⁵ That Ruling addressed the different issue of whether a corporate shareholder who buys stock after the record date is entitled to claim a dividend received deduction.³⁴⁶ The stock exchange rules, contrary to the federal tax law, provided that the buyer was entitled to receive the dividend. The corporation claimed the dividend received deduction because it was entitled to receive the dividend

342. See *supra* notes 154-55 and accompanying text.

343. *Fehrman v. Commissioner*, 38 B.T.A. 37 (1938). In *Fehrman*, a decedent's commissions salary was not ascertainable at death because it was based on net profits which were calculated at year end. The court held that the commissions were not included in the decedent's return under I.R.C. § 42 (1934) because they were not accrued. *Id.* at 42. Clearly, the taxpayer would be taxed on the commissions that he earned through his own efforts if he gave the commissions to a donee. *Helvering v. Eubank*, 311 U.S. 122 (1940). The only question was when the taxpayer would report the income. See also *Keck v. Commissioner*, 415 F.2d 531 (6th Cir. 1969); *Estate of Nilssen v. United States*, 322 F. Supp. 260 (D.C. Minn. 1971); *Collins v. United States*, 318 F. Supp. 382 (C.D. Cal. 1970), *aff'd per curiam*, 448 F.2d 787 (9th Cir. 1971).

344. See *supra* note 155 and accompanying text.

345. Rev. Rul. 82-11, 1982-1 C.B. 51.

346. The dividend received deduction is a deduction allowed to corporations for dividends received as shareholders in another corporation. I.R.C. § 243 (1988). The deduction eliminates, at least partially, the double taxation on intercorporate dividends that would otherwise exist. Generally, the corporation is entitled to a deduction of 70% of the dividends received. *Id.* §243(a)(1). If the tax-paying corporation owns more than 20% of the corporation issuing the dividend, then the amount of the deduction is 80%. *Id.* §243(c). Furthermore, if the dividends are received by a corporation which is part of the same affiliated group, then the tax-paying corporation is entitled to a full 100% deduction. *Id.* §243(a)(3).

under the stock exchange rules. Revenue Ruling 82-11 held that the stock exchange rules do not take precedence over federal tax law as promulgated in Treasury Regulation 1.61-9(c).³⁴⁷ Therefore, with transfers after the record date, the seller is entitled to the dividend because he was the owner on the record date, and the buyer is not entitled to claim a dividend received deduction regardless of the stock exchange rules.

The court quoted language from this Ruling to the effect that the holder of the stock on the record date is entitled to receive the dividend.³⁴⁸ This point is not disputed. The fact that one person is entitled to receive income, however, is not determinative of who pays the tax. In *all* assignment of income cases, the donee is entitled to receive the income while the donor is taxable.³⁴⁹

Revenue Rulings in related areas imply that the right to the dividend vests on the declaration date. Revenue Ruling 69-130,³⁵⁰ addressing redemptions of stock by the corporation after the declaration of a dividend, held that a portion of the redemption proceeds equivalent to the declared dividend is treated as a dividend distribution.³⁵¹ The Ruling stated that "[w]hen a dividend has been declared the shareholders have an immediate vested right against the corporation in the capacity of creditors. Therefore, a dividend when declared becomes the separate property of a shareholder entirely disconnected from the stock."³⁵²

Revenue Ruling 74-562 also implied that the right to the dividend vests on the declaration date.³⁵³ The Ruling held that an estate that assigns stock after the declaration date but before the payment date is taxable on the dividend.³⁵⁴ Although the Ruling is not dispositive because the declaration and record dates fell on the same date, the Ruling supported its position by citing to *Estate of Smith*.³⁵⁵ Addressing the question of whether a dividend vests on the declaration date or record date, the court in *Estate of Smith* held that the right vests on the declaration date.³⁵⁶ In sum, both of these Rulings, while not providing direct precedential value, suggest that the donor in *Caruth* should be taxed.

2. *Caruth Erroneously Ruled that Dividend is Vested on Record Date under State Law*

In *Caruth*, the court claimed that the right to the dividend vested on the

347. Rev. Rul. 82-11, 1982-1 C.B. 51, 52.

348. *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989).

349. For example, in the seminal case of *Lucas v. Earl*, 281 U.S. 111, 114 (1930), the wife was legally entitled to one half of her husband's salary. *Id.*

350. Rev. Rul. 69-130, 1969-1 C.B. 93.

351. *Id.*

352. *Id.*

353. Rev. Rul. 74-562, 1974-2 C.B. 28.

354. *Id.*

355. *Id.*

356. *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961), *cert denied*, 368 U.S. 967 (1962); see *supra* note 241-44 and accompanying text.

record date under Texas state law.³⁵⁷ In reality, under the state law of Texas, the state of incorporation in this case, the dividend vests on the declaration date.³⁵⁸ In Texas, like most other states, the declaration of the dividend creates a debtor/creditor relationship.³⁵⁹ Thereafter, the shareholder has an irrevocable claim to the dividend. In support of its position, the court cited the Texas statute³⁶⁰ enabling corporations to set a record date. The Texas statute, however, merely states that the shareholder on the record date is entitled to receive the dividend.³⁶¹ Most other states have essentially the same statute,³⁶² including those states that provide that the dividend vests on the declaration date.³⁶³ These statutes were created primarily to protect the corporation from liability after payment.

In fact, the New Jersey statute in *Estate of Smith* provided that the shareholder on the record date was entitled to the dividend.³⁶⁴ The court in that case, however, ruled that the dividend vests on the declaration date because the donor had a right to the dividend as of the declaration date, notwithstanding that the donor had transferred his shares and was, therefore, not entitled to receive the dividend.³⁶⁵ Certainly, the fact that the donee is entitled to receive the dividend is irrelevant, because in all assignment of income cases, the donee is entitled to receive the income.³⁶⁶ Similarly, the mere fact that the state statute provides that the shareholder on the record date has legal title to the dividend does not mean that the right to the dividend is created on that date or that a dividend has been earned.

Many state courts have held that a dividend vests on the record date.³⁶⁷ Basing their decisions on the "Connecticut Rule," these courts adopted its result but failed to adopt its reasoning.³⁶⁸ Under Connecticut law, the debtor/creditor relationship is created on the record date.³⁶⁹ These courts, therefore, ignored the question of when a debtor/creditor relationship was created in their respective states. As a result, the shareholder becomes a creditor of the

357. *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989).

358. TEX. BUS. CORP. ACT ANN. art. 2.26(A) (Vernon 1980 & Supp. 1990).

359. *Commissioner v. Cohen*, 121 F.2d 348, 349 (5th Cir. 1941); *McKelvy v. United States*, 478 F.2d 1217, 1235 (Ct. Cl. 1973) (Skelton, J., dissenting); *Keller v. Keller*, 135 Tex. 260, 266, 144 S.W.2d 308, 311 (1940).

360. TEX. BUS. CORP. ACT ANN. art. 2.26(A) (Vernon 1980 & Supp. 1990). The statute provides in relevant part: "For the purpose of determining shareholders entitled to . . . receive a . . . dividend, . . . the board of directors of a corporation . . . may fix in advance a date as the record date for any such determination of shareholders"

361. *Id.*

362. See 7 Z. CAVITCH, *supra* note 183, § 141-04[1], at 141-44 n.13.

363. *E.g.*, N.J. STAT. ANN. § 14A:5-7 (West 1969 & Supp. 1989); N.Y. BUS. CORP. LAW § 604 (McKinney 1986).

364. N.J. STAT. ANN. § 14:5-3 (West 1939).

365. See *supra* notes 241-44.

366. See *supra* note 315 and accompanying text.

367. See *supra* note 226 and accompanying text.

368. Note, *supra* note 25, at 438.

369. *Richter & Co. v. Light*, 97 Conn. 364, 116 A. 600 (1922).

corporation on the declaration date, although in these states the dividend is said to vest on the record date.³⁷⁰

Despite the lack of a sound theoretical basis, these cases still do not support the *Caruth* court's decision. These decisions all dealt with the separate question of to whom the dividend was payable. Since the whole purpose of the record date is to establish to whom the dividends are payable, these decisions are entirely logical in their holding that the shareholder on the record date is entitled to receive the dividend. These decisions, however, only determine to whom the dividend is payable, and not when the right to the dividend was first created.

The Connecticut state court in *Richter* suggested that the corporation's board of directors should be free to adopt a date upon which the corporation's liability should begin.³⁷¹ This reasoning, however, is specious. A corporation cannot decide when it will become liable for the dividend, and correspondingly, when the shareholder becomes a creditor. State law determines when the corporation's liability begins. In most states, the declaration of a dividend creates a liability to each shareholder. Once the right has ripened under state law, there is nothing the corporation can do to change the time when the right shall begin to exist.³⁷²

The fact that the legal title or ownership attaches to the dividend on the record date is of no consequence.³⁷³ In *Estate of Applestein*, the donor had a right to merger proceeds before he obtained legal title to the merger proceeds on the effective date of the merger.³⁷⁴ Similarly, the shareholders in the liquidation cases—*Hudspeth*, *Kinsey*, and *Jones*—had a right to the liquidating proceeds before legal title to the proceeds arose.³⁷⁵ Therefore, the precise time at which the stockholder acquires legal title is irrelevant in determining when the dividend should be considered earned.

3. The Proper Analysis

The creation of the right to the dividend does not depend on the refinements of legal title, but on the status of the shareholders. As one commentator has

370. See *supra* note 226 and accompanying text.

371. *Richter & Co. v. Light*, 97 Conn. 364, 116 A. 600 (1922); see also Note, *supra* note 25, at 439 ("While it is probable that the real intent on the part of the board of directors in making dividends payable on a record date is to protect the corporation, there is no reason why the record date cannot also be adopted as the date upon which the title to a dividend will vest.").

372. Note, *supra* note 193, at 83.

373. Justice Holmes' comment in *Corliss v. Bowers*, 281 U.S. 376 (1930), is appropriate here:

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

Id. at 377.

374. *Estate of Applestein v. Commissioner*, 80 T.C. 331, 345 (1983).

375. See *supra* notes 122-46 and accompanying text.

stated, "the rights between the parties should depend upon the ownership of the stock at the time when the corporation becomes a debtor for the dividend."³⁷⁶ On the declaration date, all indications are that the shareholder has a vested right to the dividend for tax purposes. First, the corporation must pay the dividend, or else the shareholder can sue to recover it. The *Caruth* court itself conceded that a corporation cannot revoke a dividend once it is declared.³⁷⁷ The declaration of the dividend separates an amount to be paid to each shareholder from the corporation's earnings.³⁷⁸ One court has noted that "[t]he stockholder receives the value of a dividend when it is declared, for if it is immediately paid he has his stock and his dividend, and if payment is deferred he has the value of his stock increased by the amount of the dividend upon it."³⁷⁹ No one can divest the shareholder of the dividend without his consent. No further action is required by the shareholders, board of directors, or any other party to create the right to the dividend. In short, once a dividend is declared, the shareholder is guaranteed that the dividend will be paid. Like the shareholder in *Estate of Applestein*, "[a]ll the [donor] had to do was to allow the stock to sit in [his] custodial account[] for a day or two and then hold out [his] cap to receive the proceeds."³⁸⁰

In this respect, the shareholder on the declaration date is in essentially the same position as other income earners who are guaranteed to receive money in the future. Consider the following hypothetical. On January 1st, an employer gives an employee a note which entitles the holder to the amount of one month's salary on February 1st. The employee gives the note to a donee on January 2nd. Assume that the assignment is legal under state law so that the donee is entitled to receive the salary. On January 1st, a debtor/creditor relationship is created between the employer and the note holder (the employee here). In this situation, the distributee is unknown until February 1st. It is on this date that the employer ascertains who to pay. Also, legal title to the income does not attach to the holder until February 1st. Yet, it is clear that the employee, rather than the donee, would be taxed under assignment of income principles because he earned the income. In fact, this hypothetical is merely the *Lucas v. Earl* case revisited.³⁸¹

Now consider similar facts applied to dividends. Assume that on the declaration date the corporation gives the shareholder a note entitling the holder on

376. Note, *supra* note 188, at 247.

377. *Caruth Corp. v. United States*, 865 F.2d 644, 650 (5th Cir. 1989).

378. *McKelvy v. United States*, 478 F.2d 1217, 1234 (Ct. Cl. 1973) (Skelton, J., dissenting) (quoting *Wheeler v. Northwestern Sleigh Co.*, 39 F. 347, 349 (C.C.E.D. Wis. 1889)).

379. *Commissioner v. Cohen*, 121 F.2d 348, 349 (5th Cir. 1941). Although the holding of the case, that dividends accrue on the declaration date for purposes of including them in the decedent's last tax return, has been overruled by *Estate of Putnam*, the statements made by the court concerning the status of the shareholder continue to have vitality.

380. *Estate of Applestein v. Commissioner*, 80 T.C. 331, 345 (1983).

381. In *Lucas*, the wife was legally entitled to receive half of her husband's salary if and when he earned compensation income. *Lucas v. Earl*, 281 U.S. 111, 114 (1930). The court held that the husband was taxable despite these "attenuated subtleties" because he earned the income. *Id.*

the record date to the dividend. This makes the shareholder a creditor of the corporation. The shareholder then transfers the stock and the note to a donee. This scenario is analogous to the previous hypothetical. Notwithstanding that the donee, as holder on the record date, is paid the dividend, the donor should be taxed because he assigned the right to income to the donee. The shareholder is in the same position as any other creditor³⁸² that assigns its claim against the corporation to a donee.³⁸³

The proper analysis for determining when the right to the dividend vests for federal income tax purposes is to first look to state law to determine when the debtor/creditor relationship arises. In virtually all states (including Texas, the state law at issue in *Caruth*), this occurs on the declaration date.³⁸⁴ At this point the shareholder obtains a right to the dividend. Under federal tax law, the dividend should be treated as vested on that date. If the donor gives the stock, along with this right, to a donee before the record date, then this donee is entitled to receive the dividend if he continues to hold the stock on the record date. However, the shareholder on the declaration date should still be taxed on the dividend because he had a right to the dividend at the time of the gift and transferred this right.

In states such as Connecticut, the shareholder does not become a creditor of the corporation until the record date.³⁸⁵ Consequently, the right to the dividend is created on the record date. This is the critical distinction between *Richter* and the cases that have applied its reasoning. In the interest of uniformity, however, a bright-line rule is needed. In virtually all states, the debtor/creditor relationship is created on the declaration date. Therefore, the rule that the dividends are earned on the declaration date should be adopted uniformly for all dividends.

The *Caruth* court ultimately misunderstood the nature of the shareholder's status. Under the court's view, the right to the dividend is created on the record date.³⁸⁶ The gift of the stock prior to that date would relieve the transferor of the tax on the dividend because he never had the right to receive it. This view fails to recognize the shareholder's rights to the dividend prior to the record date. The alternative view is that the right to the dividend is created on the declaration date. The gift of the stock before the record date is a transfer of both the stock and the guaranteed right to receive the dividend. Thus, the

382. *Chesapeake & Delaware Canal Co. v. United States*, 250 U.S. 123, 126-27 (1919). The Court noted that "here the [stockholder] is pursuing a right to recover, which is not affected by its relation to the corporation as a stockholder. The declaration of the dividends . . . gave it the status of a creditor . . . and, thereafter, the right to recover was unaffected by any stockholder relation." *Id.* at 126. The Court emphasized that "[t]he [stockholder] is not suing as a stockholder; it is suing as a creditor." *Id.* at 127.

383. A regular creditor that assigns the right to receive the debt proceeds is clearly taxed on the proceeds even if the right to the proceeds is contingent.

384. See sources cited *supra* note 188.

385. *Richter & Co. v. Light*, 97 Conn. 364, 116 A. 600 (1922).

386. *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989) ("Caruth never enjoyed any legal right to the dividend [T]he right to dividends vests as of the record date.").

donor should be taxed on the dividend under the principles of *Horst*.

While the difference in these two views produce different tax consequences for the gift of stock, both views produce the same tax consequences for the sale of stock. Under either view, the buyer is taxed on the dividend when he buys the stock between the declaration date and the record date pursuant to Treasury Regulation 1.61-9(c). Since the parties generally adjust the selling price of the stock to reflect the value of the dividend,³⁸⁷ it would be unfair to tax the seller on both the dividend and the full amount of the sales proceeds. Upon a sale, the seller has fully realized his income,³⁸⁸ in the form of the sale proceeds, and the buyer acquires the right to the dividend. Consequently, Treasury Regulation 1.61-9(c) provides that the buyer, and not the seller of the stock, pays the tax on the dividend.³⁸⁹

Since the seller does not pay the tax on the dividend when the stock is sold, one might ask why there should be a distinction between sales and gifts.³⁹⁰ In both situations, the transferor has realized the income: in a sale, the seller's realization of the income is in the form of the sale proceeds; in a gift, the donor's realization, according to the teaching of *Horst*, is in the form of an intangible satisfaction associated with making a gift.³⁹¹ Since a donor theoretically realizes the dividend income the same as a seller at the time of the transfer, the question arises as to why the donor should be taxed on the dividend. The answer is that a donor realizes the income from the dividend when the dividend is received by the donee,³⁹² while a seller realizes the sale proceeds he receives at the time of the transfer.³⁹³ As mentioned above, it would be unfair for the seller to pay tax on both the sales proceeds and again on the dividend. Therefore, Regulation 1.61-9(c) relieves the seller of the tax liability.

This distinction between sales and gifts is followed in other areas. Generally, the taxpayer who sells earned income pays tax on the sale proceeds and is

387. 7 Z. CAVITCH, *supra* note 183, § 141.04[3], at 141-53.

388. Interestingly, the sales proceeds are treated by the seller as a capital gain rather than as ordinary income where sold between the declaration and record date. Treas. Reg. 1.61-9(c) (as amended 1964). Under the *P.G. Lake* doctrine, a sale that is a substitute for ordinary income will cause the sale proceeds to be taxed as ordinary income rather than as a capital gain. In this respect, the tax law in this area ignores the sale of the right to the dividend from the seller to the buyer and gives the seller capital gain treatment for the entire gain on the sale. Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ J-2708. This rule is grounded in administrative convenience. B. BITTKER & J. EUSTICE, *supra* note 72, ¶ 7.07, at 7-46. It allows shareholders a grace period between the declaration date and the record date where the shareholder can sell the stock and still receive capital gain treatment. In this manner, Regulation 1.61-9(c) provides certainty in the complex area of traded securities.

389. Treas. Reg. 1.61-9(c) (as amended 1964).

390. See *supra* notes 100-05 and accompanying text (discussing the distinction between sales and gifts).

391. See *supra* notes 54-59 and accompanying text.

392. Since the gift itself is not taxable under § 102, the taxable event occurs when the donee receives the dividend. See *supra* note 58.

393. The sales proceeds are realized under § 1001(b) and the amount in excess of the taxpayer's basis is included in income under § 61(a)(3).

relieved of the tax liability on the income when it is collected.³⁹⁴ For example, in *Estate of Stranahan v. Commissioner*, the taxpayer, who sold the right to future undeclared dividends but retained the underlying stock, was not taxable on the future dividend.³⁹⁵ Similarly, in *Cotlow v. Commissioner*, a taxpayer who sold the rights to previously earned insurance commissions was not held taxable on the commissions.³⁹⁶ If the taxpayers in both of these cases had donated instead of sold the right to the income, then they would have remained taxable on the income.³⁹⁷ Thus, the fact that the seller of stock between the declaration date and record date does not pay tax on the dividend does not end the analysis. Whenever a taxpayer sells the right to income, he realizes the income at the time of the sale instead of when the income is received by the buyer. Therefore, the taxpayer is not taxable when the income is collected.

B. Right to Dividend is Sufficiently "Ripened" on Declaration Date

Even if the court was correct in determining that the dividend vests on the record date, the donor in *Caruth* should have remained taxable on the dividend because it was "earned"³⁹⁸ on the declaration date. The right to the dividend, even if not fixed and vested, had sufficiently matured on the declaration date.

1. Income Can Be Earned Before It Is Vested

The court ruled that the right to the dividend vests on the record date.³⁹⁹ The court found this to be conclusive and ended further analysis. In analogous cases, however, income is often earned before it becomes fixed and absolute. The right to proceeds from a contingent contract becomes fixed when the contract is complete. However, the income from the contract is earned at an earlier time, the time when the services were actually performed under the contract.⁴⁰⁰ Similarly, the right to liquidation proceeds becomes fixed when all assets are sold and the corporation is ready to make the final distribution. The income is earned, however, when the corporation adopts a plan of liquidation, and the right to the liquidation proceeds arises.⁴⁰¹ In *Estate of Applestein*, the right to the merger proceeds became fixed on the effective date of the merger.

394. See *supra* notes 100-05 and accompanying text.

395. *Estate of Stranahan v. United States*, 472 F.2d 867 (6th Cir. 1973).

396. *Cotlow v. Commissioner*, 228 F.2d 186 (2d Cir. 1956).

397. *Hyman v. Nunan*, 143 F.2d 425 (2d Cir. 1944) (holding donor taxable on dividends where donor donated right to future dividends but retained ownership of the stock); *Helvering v. Eubank*, 311 U.S. 122 (1940) (holding donor taxable on insurance commissions gratuitously transferred).

398. See *supra* notes 162-63 (discussing the concept of "earned").

399. *Caruth Corp. v. United States*, 865 F.2d 644, 649 (5th Cir. 1989).

400. See *supra* note 155 and accompanying text.

401. Note, *supra* note 120, at 694 ("[L]iquidation proceeds are, in effect, 'earned' at the time the shareholders of a corporation vote to liquidate.").

The court, however, considered the merger proceeds earned when the shareholders approved the merger agreement.⁴⁰² In all of these merger and liquidation cases, the donors transferred the right to income before the right was absolutely fixed, but they were still taxed on the income, despite the lack of absolute certainty, because they had earned it.

Determining when dividend income is earned is a difficult matter. In the liquidation and merger cases, cases dealing with income from stock, the income was considered earned at the time the right to the income arose, rather than the time when the income was absolutely fixed.⁴⁰³ Applying this reasoning to the dividend in *Caruth*, the dividend was earned on the declaration date, because on this date, the shareholder had a right as a creditor to the dividend.

2. *A Practically Certain Right Is Sufficiently Ripened*

The level of certainty in the right to the income is crucial to determining whether the donor should be taxed. Generally, if a donor makes a gift of a relatively uncertain right to income, the donor is not taxed on the income.⁴⁰⁴ Thus, where a donor makes a gift of a lottery ticket that turns out to be a winning ticket, he is not taxed on the income because the right was too uncertain at the time of the gift.⁴⁰⁵ Similarly, a taxpayer who assigns the rights in a lawsuit before the case is adjudicated is not taxed on the judgment award if it is too uncertain at the time of the gift.⁴⁰⁶

At the other end of the spectrum, an assignment of a certain right to income does not shift the tax burden.⁴⁰⁷ Clearly, where the right to income is already fixed and absolute, the donor cannot avoid the tax liability by means of a transfer. This is the essence of the assignment of income doctrine. This also holds true, however, in situations where the right is not quite fixed and absolute, but is "practically certain" to be realized.⁴⁰⁸

The liquidation cases held that the donor is taxed when he transfers a "practically certain" right to income.⁴⁰⁹ In these cases, the taxpayer donated

402. See *supra* notes 147-53 and accompanying text.

403. See *supra* notes 120-21, 150-53 and accompanying text.

404. See *supra* note 177 and accompanying text.

405. *Id.*

406. See *supra* notes 169-73 and accompanying text.

407. *E.g.*, *Helvering v. Horst*, 311 U.S. 112 (1940) (holding donor that transferred right to interest on bond taxable on the interest).

408. To modify the court's own "golden-egg" metaphor, see *Caruth Corp. v. United States*, 865 F.2d 644, 646 (5th Cir. 1989), imagine a gander that lays eggs which are guaranteed to hatch into healthy goslings. In this scenario, the property is the "gander" and the income is the "gosling." If the owner donates the gander before it lays an egg, then the donor should not be taxed on any future goslings. This transaction is equivalent to a taxpayer donating stock before the declaration date. However, if the owner donates the gander after it lays an egg, then the donor should be taxed on the gosling. Since the egg was guaranteed to hatch, the owner "derived money's worth" by selling the gander and the egg for the price of two geese. Similarly, a stockholder who donates stock after the declaration date and before the record date should be taxed on the dividend because the dividend is guaranteed to be paid.

409. *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976); *Kinsey v. United States*, 477 F.2d

stock to a donee after the corporation adopted a plan of liquidation but before the right to the liquidation proceeds was fixed and absolute. The liquidation was theoretically revocable by the shareholders at the time of the gift. The courts chose to examine the "realities and substance" of the transaction rather than remote possibilities. These courts held that since the liquidation was practically certain to occur, the right to the liquidation proceeds had "sufficiently ripened" to the extent that the donor could not escape the tax liability.⁴¹⁰

It must be emphasized that since the liquidation plan was revocable by the shareholders, the shareholders did not have a fixed and absolute right to the liquidating proceeds until all of the assets were actually sold. Nevertheless, the donor was taxable on the proceeds where he transferred the stock after the corporation adopted the plan of liquidation.

Similarly, *Estate of Applestein* held that the gift of stock after the shareholder approved a merger agreement but before the effective date of the merger did not shift the tax burden because the merger was practically certain to occur.⁴¹¹ The court stated that, generally, "the donor remains liable for the tax on income later received by the donee where the occurrence of a specific event with respect to that property creates the right to the income at the time of the transfer In such cases, the 'fruit had ripened' before the transfer."⁴¹²

The reasoning of the liquidation and merger cases should be applied to the transfer of stock with dividend between the declaration and record dates. In applying this reasoning, the donor should be taxed because he had a sufficiently ripened right to receive income and gave this right to the donee. A dividend, once declared, is even more certain than a liquidation or merger to be completed. As the *Caruth* court conceded, a corporation cannot revoke the payment of a dividend once it is declared.⁴¹³ If the corporation does not pay the dividend, the shareholders can sue the corporation in the capacity of creditors.⁴¹⁴ Also, the record date is usually a short time after the declaration date.⁴¹⁵ In *Caruth*, the record date was only seven days after the declaration date.⁴¹⁶ In contrast, the payment of the liquidating proceeds can occur up to

1058 (2d. Cir. 1973); *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972); see *supra* notes 122-46 and accompanying text.

410. See *supra* notes 117-46 and accompanying text.

411. See *supra* notes 147-53 and accompanying text.

412. *Estate of Applestein v. Commissioner*, 80 T.C. 331, 344-45 (1983) (citations omitted) (citing *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961) (holding donor who transferred stock after declaration date but before record date taxable on the dividend)).

413. *Caruth*, 865 F.2d at 650.

414. See *supra* notes 119, 122 and accompanying text.

415. 7 Z. CAVITCH, *supra* note 183, § 141.04[3], at 141 (stating that modern practice is to set the declaration, record, and payment dates close together).

416. *Caruth*, 865 F.2d at 647. The declaration date was on May 8, 1978, the record date was on May 15, 1978, and the payment date was on May 17, 1978.

twelve months after the adoption of the plan of liquidation.⁴¹⁷ The contingency involved with declared dividends is not that they might not be paid, but that legal title does not attach to the dividends until the record date. Thus, the contingency is not in the existence or certainty of the dividend. Instead, the contingency relates to the mere passage of time.

When income is practically certain to occur, the same justifications exist to tax the taxpayer as exist when the income is absolutely certain to occur. A person who has earned income is taxed on the income because he is the one who realizes the benefits of the income.⁴¹⁸ In terms of the *Horst* decision, the enjoyment of the income is realized whether the taxpayer makes a gift of the income, or alternatively, collects the income and then disposes of it.⁴¹⁹ Similarly, even though the shareholder does not have a fixed and absolute right regarding liquidations, the shareholder also "enjoys" the income when he makes a gift of the stock.⁴²⁰ The court in *Hudspeth v. United States* reasoned that the shareholder who donated his stock to a charity after the plan of liquidation was adopted, but before the right was absolute, "procure[d] the satisfaction of his desire to the same extent as if he had first received said proceeds and then donated them."⁴²¹

The taxpayer in *Caruth* certainly procured satisfaction from the dividend income. Without the dividend, the stock had a value of \$100.⁴²² Since no other dividend was ever declared in the history of the corporation,⁴²³ the value of the stock did not gradually increase over time in anticipation of a regular dividend distribution. Rather, the stock's value remained constant until the declaration of the \$1500 per share dividend, which naturally increased the stock's value to \$1600.⁴²⁴ Thus, the taxpayer procured the satisfaction of making a \$1600 gift instead of a \$100 gift. Furthermore, the taxpayer obtained the intangible satisfaction of establishing a fund in his own name. Where a taxpayer is virtually certain that income will be realized from his property and gives this property away, he derives the satisfaction of making a gift of both the property and the income.

417. Before it was changed in 1986, § 337 provided a liquidating corporation twelve months after the plan of liquidation was adopted to sell all of its assets without recognizing gain or loss. I.R.C. § 337 (1954).

418. *Helvering v. Horst*, 311 U.S. 112 (1940).

419. *Id.* at 117; see *supra* notes 58-59 and accompanying text.

420. *Hudspeth v. United States*, 471 F.2d 275, 280 (8th Cir. 1972).

421. *Id.*

422. Like many closely held corporations, Caruth Corporation's stock did not have an ascertainable market value. See *Caruth Corp. v. United States*, 865 F.2d 644, 648 (5th Cir. 1989). Since the stock was callable at \$100, *Id.* at 647, the stock's value without the dividend could not be more than \$100. See Brief for Appellant at 10 n.8, *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015).

423. *Caruth*, 865 F.2d at 647.

424. *Id.* at 648.

C. Substance Over Form

While the preceding discussion focussed on the application of the assignment of income doctrine in a general sense to all gifts of stock between the declaration and record dates, the fact that the taxpayer in *Caruth* was a controlling shareholder of a closely held corporation presents an even more compelling case for taxing the donor.

The substance over form doctrine generally allows the IRS to ignore formalities and assess taxes based on the economic reality of the transaction.⁴²⁵ The court in *Caruth* focused on the fact that the record date was set by the corporation for a legitimate business purpose and ended further analysis.⁴²⁶ This, however, ignores the realities of the transaction. In substance, the taxpayer was looking for a way "to get money out of" the corporation because he was planning to wind down operation of the corporation.⁴²⁷ He was aware of the potential unfavorable impact of the accumulated earnings tax.⁴²⁸ The taxpayer was allowed to divert some of the accumulated earnings of his corporation, attach these earnings to the stock, and then transfer them to a charity tax-free. This was accomplished by declaring a dividend and then transferring the stock before the record date. As a result, the taxpayer claimed a charitable deduction for the \$1,500,000 dividend but did not include the dividend in income.⁴²⁹

By having control over the corporation, the taxpayer had many options open to his discretion, such as deciding when a dividend would be declared. Since the stock contained a call provision,⁴³⁰ he could direct the corporation to buy back any outstanding stock with thirty days notice. In addition, he could determine the amount of the dividend. These factors demonstrate the large amount of control the *Caruth* taxpayer had over the nature and extent of the dividend income.

Similarly, the fact that North Park Corporation was a closely held corporation is significant. Because the corporation did not pay out regular divi-

425. See *supra* notes 245-48 and accompanying text.

426. *Caruth*, 865 F.2d at 650. The court ruled that the taxpayer directed the corporation to set a record date in order to encourage his estranged nephews to sell their shares to him. *Id.* The IRS contended that the setting of a record date could in no way serve to overcome the nephew's unwillingness to sell their shares. Reply Brief for Appellant at 6 n.4, *Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015).

427. *Caruth Corp. v. United States*, 865 F.2d 644, 647 (5th Cir. 1989).

428. *Id.* The accumulated earnings tax, imposed by § 532, is designed to prevent corporations from accumulating income in the corporation and thereby avoiding the taxation of a dividend to the shareholders. To avoid the tax, corporations are only allowed to accumulate earnings to meet reasonable needs and must distribute the rest. See B. BITTKER & J. EUSTICE, *supra* note 72, ¶ 8.02.

429. *Caruth*, 865 F.2d at 648.

430. *Id.* A call provision allows the corporation to redeem a shareholder's stock upon its discretion. The stock in *Caruth* was callable at \$100 and required the corporation to give the shareholder 30 days notice prior to redeeming the stock. *Id.*

dends,⁴³¹ the value of the stock did not gradually increase in anticipation of the record date. In fact, the corporation's stock, like most other stock not publicly traded, did not even have a market value before the dividend was declared.⁴³² Once the dividend was declared, the value of the stock was ascertained at \$1600 per share, reflecting the \$1500 dividend.⁴³³ This principle is important because it essentially prevented the taxpayer from accomplishing the same result as that which occurred in the case by merely transferring the stock one day before the declaration date. A transfer before the declaration date would not accomplish the same result because the value of the stock did not include the value of the dividend. Therefore, the taxpayer would not be able to claim an enhanced charitable deduction. Thus, in closely held corporations where a dividend is not anticipated, the taxpayer can attach the amount of the dividend on to the stock merely by declaring a dividend.

By exercising his control over the corporation, the taxpayer was able to assign income to the charity. If he had donated his stock after the record date, then he would have been able to claim the charitable deduction, but he would have had to pay tax on the dividend.⁴³⁴ Essentially, the taxpayer can deduct the amount of the dividend and escape taxation on the dividend only during the period between the declaration date and the record date. Since the taxpayer had control over the corporation, he could determine when that period would occur. He would essentially be able to enhance every charitable donation he made simply by declaring a dividend before he donated the stock. This arrangement is especially poignant where the corporation is forced to make the donation for less philanthropic reasons, such as to avoid an impending accumulated earnings⁴³⁵ tax or personal holding company tax.⁴³⁶

IV. IMPACT

The most direct impact of *Caruth* is that it will allow shareholders of closely held corporations to enhance the value of a gift. In closely held corporations, dividends usually are not paid regularly and, therefore, are not anticipated.⁴³⁷ As a result, once a dividend is declared, the value of the stock increases suddenly.⁴³⁸ For example, assume that the market value of preferred stock with-

431. *Id.* The dividend distribution at issue in the case was the only dividend the corporation ever paid out.

432. *See id.* The taxpayer stated that since there was no one else in the market for the shares, he would provide a market himself. *Id.*

433. *Id.*

434. Rev. Rul. 74-562, 1974-2 C.B. 28 (holding that donor who donates stock after record date is taxable on the dividend).

435. An example of this situation is the taxpayer in *Caruth*. He sought to avoid the unfavorable impact of the accumulated earnings tax by distributing a dividend to the charity.

436. *E.g.*, Estate of Smith, 292 F.2d 478 (3d. Cir. 1961) (holding that taxpayer made dividend distribution to avoid the personal holdings tax).

437. *See supra* notes 395-96 and accompanying text.

438. *Caruth Corp. v. United States*, 865 F.2d 644, 646 (5th Cir. 1989). The court observed that "[w]ith the declaration of a dividend, the asset appreciates suddenly, and then declines again

out the dividend is \$10,⁴³⁹ and the corporation declares a \$500 dividend, which increases the value of the stock to \$510.⁴⁴⁰ If a shareholder wishes to make a gift, he need only wait until a dividend is declared, or if he is a controlling shareholder, he can direct the corporation to declare the dividend and then be sure to transfer the stock before the record date. This will allow him to obtain the benefit⁴⁴¹ of making a \$510 gift without paying tax on the \$500 dividend. If the gift is to a charitable organization, he could then claim a charitable deduction of \$510.⁴⁴²

When a shareholder desires to make a donation, he is much better off donating the stock during this period than selling the stock and donating the proceeds. If he sells the stock, he must pay tax on any gain he realizes from the sale.⁴⁴³ If he donates the stock, not only is the dividend excluded from income according to *Caruth*, but also the shareholder can claim a charitable deduction, although this may be limited if the alternative minimum tax applies.⁴⁴⁴

More importantly, *Caruth* permits shareholders to assign the right to dividend income. This allows the shareholders to procure not only intangible benefits, but also tangible economic benefits as well. Instead of donating the "pregnant" stock to a charity, the shareholder could transfer it to business associates. For example, a controlling shareholder can transfer pregnant stock to a creditor in satisfaction of a debt. Again, assume preferred stock is worth \$10 and a \$500 dividend is declared, increasing the stock's value to \$510. Further assume that the shareholder owes a creditor \$510. If the shareholder is a majority shareholder, then he can arrange for the corporation to declare a

to its par value (or below) when the dividend issues." *Id.*

439. Since there is no ready market of buyers available, the value of the bare stock is necessarily low. However, the value of all the corporation's stock should approximate the fair market value of the corporation's assets. *Eli Lilly & Co. v Commissioner*, 856 F.2d 855 (7th Cir. 1988); see also *Nash v. United States*, 398 U.S. 1, 4 (1970) (holding that taxpayers who transferred intangibles in exchange for stock received the equivalent of the corporation's assets).

440. The particular numbers used are not relevant. Any amounts would convey the same principle that the shareholder can use the dividend income tax-free by having the power to dispose of the income as he wishes.

441. The satisfaction could come through publicity, improved public relations, or simply the philanthropic desire to make a gift. The taxpayer in *Caruth*, for example, designated that his donated shares be placed into the "W.W. Caruth Jr. Fund." *Caruth Corp. v. United States*, 688 F. Supp. 1129, 1131 n.6 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989).

442. This could be limited by the alternative minimum tax (AMT). I.R.C. §§ 55-59 (1988). Congress enacted the alternative minimum tax in 1986 to prevent taxpayers from significantly avoiding tax liability through use of tax preferences. AMT is only payable if it exceeds the taxpayer's regular tax liability. AMT is calculated on the taxpayer's taxable income after certain adjustments are made to reflect these tax preferences. One such adjustment is the appreciated portion of property claimed as a charitable deduction. *Id.* § 57(a)(6). This may prevent the taxpayer from receiving the benefit of a charitable deduction. B. BITTKER & J. EUSTICE, *supra* note 72, ¶ 5.08.

443. The gain realized on the sale of the stock is the amount realized of \$510 less the shareholder's basis in the stock.

444. See *supra* note 442.

dividend at his convenience. The shareholder can then transfer a share of stock to a creditor in satisfaction of the \$510 loan balance. The creditor has no complaints since his loan is paid. Yet, according to *Caruth*, the shareholder does not pay tax on the \$500 dividend. This allows him to extract money from the corporation to pay off the \$510 debt tax free. If the shareholder were instead to sell the stock and then pay the creditor with the proceeds, he would have to pay tax on any gain realized from the sale.⁴⁴⁵

Similarly, under *Caruth*, shareholders can purchase property with the pregnant stock. The value of the dividend attached to the stock would constitute consideration for the purchase. Under the same facts as above, the shareholder would be able to purchase a piece of property worth \$510 by transferring a share of stock between the declaration and record dates. Again, the shareholder would not be taxed on the \$500 dividend according to *Caruth*.

These examples demonstrate the irrationality of *Caruth*. The shareholder is allowed to use the dividend income to his satisfaction without paying tax on it. The reasoning of *Horst* precluded such a result. "Even though [the donor] never receives the money, he derives money's worth from the disposition The enjoyment of the economic benefit . . . is realized as completely as it would have been if he had collected the interest in dollars and expended them."⁴⁴⁶

More generally, *Caruth* may indicate a setback for the assignment of income doctrine. The Fifth Circuit might not follow the holdings of other circuits in the liquidation cases. Instead, it could very well hold that a shareholder is not taxable where it assigns stock after a plan of liquidation is adopted. The decision might also affect the level of certainty required to hold the donor taxable on income that is not fixed and absolute. *Caruth* might require an absolutely vested right while discarding the "practically certain" approach in the process.

V. CONCLUSION

Caruth held that a taxpayer who donates stock before the record date is not taxable on the dividend. This approach is inconsistent with other areas involving the assignment of stock. It allows shareholders who are certain that a dividend will be paid to derive a benefit by disposing of the dividend as they wish. According to the assignment of income doctrine, this power to dispose of income is grounds for tax liability.

The court ignored the fact that once a dividend is declared, the shareholder becomes a creditor of the corporation. As such, he should be treated as any other creditor that transfers its claim against the corporation, and he should be taxed on the dividend. The right to the dividend, therefore, arises on the declaration date. It is true that the shareholder actually owning the stock on the record date, not necessarily the shareholder on the corporate books, is enti-

445. The gain on the sale would be the \$510 less the shareholder's basis in the stock.

446. *Helvering v. Horst*, 311 U.S. 112, 117 (1940).

tled to receive the dividend. But the fact that one person is entitled to receive income is not determinative of who pays the tax on it, according to the assignment of income doctrine. Upon the gift of the stock between the declaration and record dates, the donor must pay the tax on the dividend even though the donee receives the dividend. This rule will not affect the sale of stock during the same period. Thus, upon the sale of the stock, the seller pays tax on the sales proceeds realized from the sale while the buyer receives the dividend and pays tax on it.⁴⁴⁷ These rules provide rational results for a "peculiar asset."

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447. Treas. Reg. 1.61-9(c) (as amended 1964).